



Senate Tax Reform Bill - Initial Observations on Finance Committee Bill

November 18, 2017

kpmg.com

CAUTION: This report is based on "conceptual" documents available as of November 17. Bill text is not yet available and details may be further refined before text is released. Significant changes also may be made as the bill moves through the process (including the addition of Senate floor amendments). We will release an updated version of this report if the Senate approves tax reform legislation. In the interim, you can find more information on the *TaxNewsFlash-Tax Reform* page about tax reform developments.



Introduction

On November 16, 2017, the Senate Finance Committee approved its version of tax reform legislation (the “Tax Cuts and Jobs Act”) by a party-line vote of 14 to 12. Senate procedures require that the bill now move to the Senate Budget Committee, followed by consideration by the full Senate.

KPMG observation

Legislative text of the bill is not yet available. By tradition, the Senate Finance Committee does “conceptual markups” from detailed summary documents and not from legislative text. Legislative text will be required, however, before consideration of the bill can begin on the Senate floor. See important caveat below regarding the possibility analysis and observations contained in this report could change once legislative text is available.

Background

On November 9, Senate Finance Committee Chairman Orrin Hatch (R-UT) released a “Chairman’s mark” of his proposed tax reform legislation.

The Finance Committee’s markup of the proposed legislation —formal consideration of the mark by the Finance Committee—began on November 13.

On November 14, Chairman Hatch unveiled a revised version of his proposed tax reform legislation (a “modified mark”) that reflected substantial changes to the initial Chairman’s mark.

On November 16, shortly before the end of the markup, Chairman Hatch released a “manager’s amendment” with additional modifications. The manager’s amendment was approved by the Committee shortly before the conclusion of the markup.

Highlights

Business provisions

Like the House bill, the Finance Committee bill includes a permanent reduction in the corporate income tax rate from 35% to 20%. However, unlike the 2018 effective date in the House bill, the 20% rate in the Finance Committee bill is not scheduled to become effective until 2019. Like the House bill, the full list of proposed changes for businesses in the Finance Committee bill is extensive, including both additional tax benefits and offsetting tax increases.

Notably, both the Finance Committee bill and the House bill would introduce “expensing” as the principal capital cost recovery regime, by increasing the 168(k) first-year “bonus”

depreciation deduction to 100%— therefore allowing taxpayers to write off the costs of equipment acquisitions as made. Importantly, however, the Finance Committee bill's proposal would generally apply only to *new* property (but not to “new” and “used” property, as the House bill proposes). The proposal also would generally apply only through 2022 (or, in some cases, 2023).

To offset the costs of these tax benefits, the Finance Committee bill would repeal or modify a number of existing provisions in the tax law. For example, the Finance Committee bill generally proposes to:

- Repeal the section 199 domestic manufacturing deduction (beginning in 2019)
- Impose a limit on interest deductibility (a limit equal to the sum of business interest income plus 30% of “adjusted taxable income”)
- Limit the carryover and carryback of net operating losses (with special rules for certain farms)
- Modify the deductibility of business entertainment expenses
- Provide significant revenue-raising changes for taxation of the insurance industry
- Require certain research or experimental (R&E) expenditures to be capitalized beginning in 2026

Multinational entity taxation

In reforming the taxation of multinational businesses, the Finance Committee bill moves in the same general direction as the House bill. Yet important differences exist that ultimately would need to be reconciled with a House bill.

Like the House bill, the Finance Committee bill would move the United States from a system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income. To accomplish this, the Finance Committee bill would adopt several features, including:

- A 100% exemption for dividends received from 10% or greater-owned CFCs
- A minimum tax on “global intangible low taxed income” (GILTI), and
- A transition to the new regime through mandatory repatriation of previously untaxed “old earnings.” A 10% rate would apply to cash and cash equivalents and a 5% rate would apply to illiquid assets.

Also, like the House bill, the Finance Committee bill proposes additional anti-base erosion measures in the new regime. The Finance Committee bill and the House bill seek similar outcomes in this regard, yet differ in approach. The Finance Committee bill does not include the related party transactions excise tax from the House bill. Instead, the Finance Committee bill would apply a “Base Erosion Anti Abuse Tax” (BEAT). The BEAT would generally have the effect of imposing a tax certain deductible payments made to a foreign affiliate, but unlike the House provision would not apply to cost of goods sold.

Like the House bill, the Finance Committee bill also includes additional limitations on interest deductions in which a U.S. corporation is part of an international financial reporting group.

The Finance Committee bill, however, includes several other international provisions not found in the House bill. These include revised treatment of hybrids, a deduction for certain foreign derived intangible income, and rules for both inbound and outbound transfers of intangibles.

These differences between the Finance Committee bill and the House bill may not be irreconcilable, but they are not insignificant and would have to be resolved in any final tax bill.

Individual provisions—subject to sunset after 2025

KPMG observation

Many of the changes affecting individual taxpayers, including repeal of the individual AMT, would cease to apply after December 31, 2025. At that time the changes would sunset with the result that the individual provisions would revert to their pre-2018 form. Future legislation would be required to make the provisions effective beyond 2025.

The sunset rule would not apply to the proposal to reduce the Affordable Care Act individual shared responsibility payment to zero or the use of the new inflation index (discussed below).

The bill would make a number of changes to the individual rate structure, as well as to deductions and credits.

The bill would retain seven tax brackets but would modify the “breakpoints” for the brackets. The temporary new brackets would be 10%, 12%, 22%, 24%, 32%, 35%, and 38.5%. The top rate would apply to single filers with income of \$500,000 and married joint filers with income of \$1,000,000.

The Finance Committee bill also includes another temporary provision that generally would allow an individual taxpayer a deduction for 17.4% of the individual’s “qualified business income” from a partnership, S corporation, or sole proprietorship. This proposed deduction is not in the House bill which, instead, attempts to accomplish a similar result through an actual reduction in the applicable tax rate for business income of individuals from partnerships, S corporations, and sole proprietorships.

The standard deduction would be temporarily increased to \$24,000 for joint filers and \$12,000 for individual filers with these deductions indexed annually. At the same time, the

deduction for personal exemptions would be repealed, while the child tax credit would be enhanced and the phase-out thresholds would be substantially increased.

The revenue cost of these changes would be offset by temporarily modifying or eliminating a number of tax preferences, many of them significant and long-standing. These include elimination of deductions for home equity loan interest and state and local income and property taxes, and modification of the exclusion of gain from the sale of a principal residence. The “Pease” limitation would be repealed.

The estate, GST and gift tax exemption amount would be doubled to \$10 million (indexed for inflation) through 2025.

Affordable Care Act modifications – “individual mandate”

The bill contains a provision that would effectively repeal the individual mandate in the Patient Protection and Affordable Care Act by reducing the individual responsibility payment under section 5000A to zero for individuals who do not purchase health insurance that qualifies as minimum essential coverage.

Alternative Minimum Tax

The corporate AMT would be permanently repealed for tax years beginning after 2017 with various rules governing the treatment of AMT credit carryovers. The individual AMT would be repealed through 2025, but would then be reinstated beginning in 2026.

Taxation of investment income

There would be no significant changes to the capital gains and dividends tax rate. The Finance Committee bill also does not include repeal of the net investment income tax.

Exempt organizations

In addition to a number of generally applicable provisions that may affect exempt organizations (e.g., reduced corporate income tax rates, changes to the deductibility of various fringe benefits, tax-exempt bond reform), the Finance Committee bill proposes a number of permanent changes that are specifically relevant to exempt organizations. For example, the Finance Committee bill would:

- Impose an excise tax on compensation in excess of \$1 million and on “excess parachute payments” paid to certain employees of exempt organizations
- Impose a 1.4% excise tax on the investment income earned by private colleges and universities with large endowments

- Modify unrelated business taxable income by including the income from the sale or license of names or logos and by requiring unrelated business taxable income to be computed separately for each trade or business
- Modify the intermediate sanctions rules applicable to excess benefit transactions

The Finance Committee bill does not include a number of notable provisions in the House bill (e.g., uniform rate for the excise tax on private foundation net investment income and a provision allowing section 501(c)(3) organizations to engage in de minimis political activity).

Excluded and new provisions

Chairman Hatch's original mark included some provisions that were stricken in the legislation that ultimately was approved by the Finance Committee. These provisions related to:

- Nonqualified deferred compensation
- Determination of worker classification
- Application of 10% early withdrawal tax to governmental section 457(b) plans
- Elimination of catch-up contributions for high-wage employees

The Finance Committee bill also includes several provisions that were added as a result of the adoption of the modified mark and the manager's amendment, including provisions that would:

- Reduce to zero the penalty for individuals who do not have health insurance (the individual mandate)
- Provide a three-year holding period with respect to certain partnership interests acquired in exchange for services (carried interest)
- Take into account charitable contributions and foreign taxes in determining limitation on allowance of partner's share of loss
- Allow nonresident alien individuals to be potential current beneficiaries of electing small business trusts ("ESBTs") and change the rules for charitable contributions of ESBTs (relevant to S corporations)
- Modify certain low income housing tax credit rules
- Repeal the rule permitting recharacterization of IRA contributions
- Change the treatment of qualified equity grants

- Change certain tax rules applicable to certain alcoholic beverages

Revenue-dependent provisions

The Finance Committee bill includes six prospective revenue-raising provisions that would be repealed if the Secretary of the Treasury determines that aggregate on-budget federal revenues for all sources for fiscal years 2018 through 2026 exceed a certain dollar figure by a certain amount. Provisions potentially subject to repeal relate to the following modifications made in the modified mark:

- Further decreasing the newly-created limitation on net operating loss (NOL) deductions of 90% of taxable income beginning in 2018 to 80% after 2022
- Disallowance of employer deduction for meals provided for the convenience of the employer on the employer's business premises effective after 2025
- Certain changes made by the modified mark to the deductions for global intangible low-taxed income (GILTI) for tax years beginning after 2025
- Certain changes made by the modified mark to foreign-derived intangible income after 2025
- Certain modifications to the tax on base erosion payments of some taxpayers after 2025
- Amortization of R&E expenditures (including reporting requirements) effective after 2025

Impact of reconciliation rules

The bill is at least partially shaped by budget reconciliation requirements.

Budget reconciliation is a process by which spending and revenue legislation (including tax measures) can avoid a potential Senate filibuster and be passed by a simple majority vote in the Senate. The ability to use these rules was "unlocked" when the House and Senate agreed to a budget resolution for FY 2018. The budget resolution permits the tax bill produced pursuant to its instructions to increase the deficit by a maximum of \$1.5 trillion over the 10-year budget window. The Finance Committee bill appears to have been structured with this revenue target in mind; the Joint Committee on Taxation (JCT) has estimated that the bill would lose approximately \$1.414 trillion over the 10-year period (not taking into account possible macroeconomic effects).

To retain the protection from a Senate filibuster that the reconciliation rules provide, provisions in the tax legislation being considered under the budget resolution must meet

a number of complex requirements. Any senator could raise a point of order against any provision that does not meet these requirements.

For tax legislation, one of the most relevant requirements is one intended to prevent an increase in the long-term deficit of the United States. Even though a tax bill considered pursuant to the FY18 budget resolution can provide a net tax cut of up to \$1.5 trillion **within** the 10-year window, no title of the Finance Committee bill can result in a net tax cut in any year **beyond** the 10-year budget window unless offset by an equivalent reduction in spending. The JCT revenue table does not show the estimated revenue effects of the Finance Committee bill in years outside this budget window.

KPMG observation

The requirements put forth by these budget rules have very likely affected the details of this draft legislation. For example, with one of the budget reconciliation requirements being that every provision must have more than an incidental effect on revenue or spending, provisions lacking a budgetary impact would potentially violate the procedural requirements. Likewise, it is possible that decisions to delay enactment dates or to include sunset dates for the individual tax changes and the passthrough deduction were at least partially related to the need to fulfill the reconciliation-imposed rules regarding long-term deficits or to avoid increasing the short-term deficit by more than the allowable \$1.5 trillion.

What is next?

On November 16, the House approved its version of the Tax Cuts and Jobs Act – H.R. 1. The House bill next proceeds to the Senate. Read [KPMG's report](#) [PDF 1.8 MB] providing observations and analysis on H.R. 1, as approved by the House.

Typically, the Senate Finance Committee would have waited to receive the House bill before it began its own markup. Article I of the Constitution requires that “all bills for raising revenue shall originate in the House of Representatives.” However, in an effort to save time, the Senate Finance Committee began its markup before the House had passed H.R. 1.

Now that the Senate Finance Committee has approved its own tax reform bill, that bill would be processed through the Senate Budget Committee as required by reconciliation rules and then would be referred to the full Senate for consideration.

As a result, once the House bill is received in the Senate, H.R. 1 might be “held at the desk” at the Senate. This procedural maneuver would allow the bill to be called up for consideration by the full Senate more quickly by avoiding referral of the bill to a Senate committee. Assuming the successful completion of a few required procedural votes, the

Senate would begin 20 hours of debate on H.R. 1, evenly divided between Republicans and Democrats. It typically would take one or more days to complete the 20 hours of debate.

The first amendment to the House bill would likely be a procedural amendment designed to move the Finance Committee bill back into compliance with Article I of the Constitution. The Finance Committee bill is expected to be presented as a “strip-and-replace” amendment to H.R. 1—i.e., that amendment would “strip” out the House-passed language in its entirety and “replace” it by inserting the text of the Finance Committee bill. The result would be that H.R. 1 would then contain only the Finance Committee approved language—the only significant remnant of the House bill would be its bill number.

During consideration by the full Senate, it is possible that amendments would be adopted on the Senate floor. It is not yet certain when Senate floor action would commence or when a vote on final passage would take place.

Based on the Finance Committee bill, it appears likely that, if the Senate approves a bill, it would be different from the House bill in some key respects. Some of the differences between a Senate bill and a House bill may relate to the need for the Senate bill to conform to the Senate rules governing budget reconciliation, the procedure under which the legislation is proceeding. (See below for more information on budget reconciliation.)

For tax reform to become law, the House and the Senate ultimately would have to pass identical legislation and send it to the president. There are different mechanisms by which this could be accomplished. It is possible that a conference committee might be convened to work out the differences between the two bills (as was done in the 1986 Act). However, other approaches might be employed. For example, House and Senate policymakers might negotiate behind the scenes before final Senate passage in an effort to produce a final amendment that would result in a bill that could pass the Senate and then pass the House. Regardless of the mechanism used, finalizing a bill that could pass both the House and the Senate could be challenging and time-consuming.

The often stated goal of Republican congressional leadership is to pass a bill and send it the president for his signature prior to the end of 2017. The aggressive schedule being pursued is aimed at meeting this deadline. Significant hiccups could still occur, whether at the Senate floor stage or in attempting to reconcile the differences.

This report: Important caveats

This report provides KPMG’s preliminary analysis and observations regarding the bill that the Finance Committee ordered reported after its “conceptual markup.” This is one of a series of reports that KPMG has prepared on tax reform legislation as it has moved through various stages of the legislative process. To read KPMG’s reports and coverage of legislative developments, see [TaxNewsFlash-Tax Reform](#).

The discussion and analysis in this report are based on the documents relevant to the Finance Committee bill that were provided to the public prior to November 17, 2017 by the Finance Committee and the JCT. Before the bill is considered by the Senate, legislative text will be prepared by the Republican staff of the Finance Committee. Staff has the “authority to make technical conforming and budgetary changes to the mark including those that might be necessary to ensure it complies with the committee’s reconciliation instruction” granted to it by the Committee. The Finance Committee may also issue a report further describing the bill.

It is possible that an examination of legislative text, a Finance Committee report, and other documents that may be released in the future could change some of the descriptions and analyses set forth below.

Documents

- [JCX-59-17](#): JCT revenue table for Finance Committee bill, including amendments
- [Manager’s amendment](#) [PDF 104 KB]
- [Correction to Chairman’s modified mark](#)
- [Chairman’s modified mark](#)
- [Chairman’s mark](#) [PDF 877 KB] - “Description of the mark” document prepared by JCT (253 pages)
- [Section-by-section summary](#) [PDF 759 KB] of the Chairman’s mark prepared by the Finance Committee (48 pages)
- [Policy Highlights](#) [PDF 127 KB] of the Chairman’s mark prepared by the Finance Committee

Contents

Individuals	17
Ordinary income tax rates—In general	17
Treatment of business income of individuals	19
Deduction of 17.4% for certain passthrough income	19
Loss limitation rules for taxpayers other than C corporations	22
Filing status, standard deductions, and personal exemptions.....	23
New indexing method	24
Tax rates on capital gains and dividends	25
Reform of the child tax and qualifying dependents credits.....	25
Repeal of certain itemized deductions and income exclusions	26
Deduction for taxes (including SALT) not paid or accrued in a trade or business...	26
Modify deduction for home mortgage interest.....	27
Increase percentage limit for charitable contributions of cash to public charities....	28
Modify deduction for personal casualty and theft losses.....	28
Repeal deduction for tax preparation expenses	28
Repeal of miscellaneous itemized deductions subject to the 2% floor.....	29
Repeal of overall limitation on itemized deductions (“Pease” limitation)	29
Modification of exclusion of gain from sale of a principal residence.....	29
Repeal of exclusion for qualified moving expense reimbursements	30
Repeal of deduction for moving expenses.....	31
Repeal of exclusion for qualified bicycle commuting reimbursement.....	31
Modification to the limitation on wagering losses	32
Estate, gift and generation-skipping transfer tax.....	32
Other.....	33
Exclude income from the discharge of student debt	33
Modification of the deduction for certain educator expenses	33
Allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver’s credit	33
Rollovers between qualified tuition programs and qualified ABLE programs.....	34
Simplify filing requirements for individuals over 65 years of age.....	34

Expand definition of section 529 plan beneficiary	35
Relief for the Mississippi River Delta flood disaster area	35
Exclusion from gross income of certain amounts received by wrongly incarcerated individuals.....	36
Combat zone tax benefits to Armed Forces in Sinai Peninsula of Egypt	37
Affordable Care Act—Healthcare	37
Reduce Affordable Care Act individual shared responsibility payment to zero	38
Alternative Minimum Tax repeal.....	38
Individual AMT	38
Corporate AMT	39
Business—In general	40
Generally applicable C corporation provisions	40
Reductions in corporate tax rate reduction and dividends received deduction	40
Modify net operating loss (NOL) deduction.....	42
Dividends paid reporting and deduction.....	44
Cost recovery.....	44
Modification of rules for expensing depreciable business assets	44
Temporary 100% expensing for certain business assets.....	45
Modifications to depreciation limitations on luxury automobiles and personal use property	46
Modifications of treatment of certain farm property.....	46
Applicable recovery period for real property	47
Requirement to capitalize section 174 research and experimental expenditures ...	48
Expensing certain citrus replanting costs.....	49
Business-related deductions, exclusions, etc.....	49
Limitation on the deduction of net business interest expense.....	49
Repeal deduction for income attributable to domestic production activities.....	53
Limitation of deduction by employers of expenses for certain fringe benefits	54
Length of service award programs for bona fide public safety volunteers	55
Limits on like-kind exchange rules	55
Accounting methods	56

Certain special rules for tax year of inclusion	56
Small business accounting	57
Increase threshold for cash method of accounting	58
Modify accounting for inventories	58
Increase exemption for capitalization and inclusion of certain expenses in inventory costs	59
Increase exceptions for accounting for long-term contracts.....	59
Business credits.....	59
Low-income housing credit	59
Modification of credit for clinical testing expenses for certain drugs for rare diseases or conditions	61
Repeal of deduction for certain unused business credits.....	62
Modification of rehabilitation credit.....	62
Employer credit for paid family and medical leave.....	63
Miscellaneous Business Provisions	63
Qualified opportunity zones	63
Alaskan Native Corporation payments and contributions to settlement trusts	64
Aircraft management services	64
Modify treatment of expenses in contingent fee cases	65
Deny deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment or sexual abuse.....	66
Expand non-deductibility of certain fines and penalties	66
Repeal deduction for local lobbying activities	67
Compensation	67
Treatment of qualified equity grants.....	67
Modification of limitation on excessive employee remuneration.....	69
Excise tax on excess tax-exempt organization executive compensation	70
Retirement savings.....	71
Conformity of contribution limits for employer-sponsored retirement plans.....	71
Repeal of special rule permitting recharacterization of IRA contributions	72
Extended rollover period for the rollover of plan loan offset amounts	72

Individuals held harmless on improper levy on retirement plans.....	73
Passthrough entities.....	74
Tax gain on the sale of a partnership interest on look-through basis.....	74
Modification of the definition of substantial built-in loss in the case of transfer of partnership interest.....	76
Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d).....	77
Partnership interest held in connection with the performance of services.....	77
S Corporations: Expansion of qualifying beneficiaries of ESBTs.....	78
Charitable contribution deduction for electing small business trusts.....	79
Other proposals relevant to passthrough entities.....	79
Banks and financial institutions.....	79
Deduction limits for FDIC premiums.....	79
Repeal of advance refunding bonds.....	80
Cost basis of specified securities determined without regard to identification.....	80
Insurance.....	82
Net operations loss deductions of life insurance companies.....	82
Net operations loss deductions of property and casualty insurance companies.....	83
Repeal small life insurance company deduction.....	83
Repeal Code section 807(f) spread—Adjustment for change in computing reserves	84
Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts.....	85
Modify proration rules for property and casualty (P&C) insurance companies.....	85
Repeal elective deduction and related special estimated tax payment rules.....	86
Capitalize certain policy acquisition expenses (DAC).....	87
Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules.....	88
Tax-exempt organizations.....	90
Excise tax on investment income of private colleges and universities.....	91
Name and logo royalties treated as unrelated business taxable income.....	91
Unrelated business taxable income separately computed for each trade or business	92
Repeal of tax-exempt status for professional sports leagues.....	93

Modification of taxes on excess benefit transactions (intermediate sanctions)	93
Exception from private foundation excess business holding tax for independently-operated philanthropic business holdings	94
Denial of deduction for college athletic event seating rights	95
Repeal of substantiation exception in case of contributions reported by donee.....	95
International	96
Establishment of participation exemption system for taxation of foreign income	96
Add U.S. participation exemption.....	96
Add special rules relating to sales or transfers involving specified 10% owned foreign corporations	98
Mandatory repatriation.....	100
Rules related to passive and mobile income.....	108
Current year inclusion of global intangible low-taxed income by United States shareholders	108
Add deduction for foreign-derived intangible income	113
Add special rules for transfers of intangible property from controlled foreign corporations to U.S. shareholders	114
Other modifications of subpart F provisions.....	115
Eliminate inclusion of foreign base company oil related income.....	115
Inflation adjustment of de minimis exception for foreign base company income ..	115
Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment.....	116
Modification of stock attribution rules for determining status as a controlled foreign corporation.....	116
Modification of definition of United States shareholder	117
Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply	117
Look-thru rule for related controlled foreign corporations made permanent	118
Corporations eligible for deductions for dividends exempted from subpart F inclusions for increased investments in United States property	119
Prevention of base erosion	119
Deny deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic interest	119

Adds limitations on income shifting through intangible property transfers	122
Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities.....	123
Terminate special rules for domestic international sales corporations.....	125
Surrogate foreign corporations not eligible for reduced rate on dividends	126
Modifications related to foreign tax credit system	126
Repeal section 902 indirect foreign tax credits; determination of section 960 credit on a current-year basis	126
Separate foreign tax credit limitation basket for foreign branch income.....	127
Acceleration of election to allocate interest on a worldwide basis.....	128
Determine source of income from sales of inventory solely on basis of production activities	129
Inbound provisions	130
Add base erosion and anti-abuse tax	130
Other provisions.....	134
Tax passenger cruise gross income of foreign corporations and nonresident alien individuals.....	134
Modify insurance exception to the passive foreign investment company rules	134
Repeal fair market value method of interest expense apportionment.....	136
Modify source rules involving possessions	136
Repeal exclusion applicable to certain passenger aircraft operated by a foreign corporation.....	137
Modify Code section 4985 excise tax	137
CRAFT beverages/excise taxes on beer, wine, and distilled spirits	138
Exempt the aging period of beer, wine and spirits from UNICAP rules related to interest	138
Reduced rate of excise tax on beer	138
Simplification of rules regarding records, statements and returns.....	139
Transfers of beer in bond.....	139
Reduced rate of tax on certain wine.....	140
Adjust alcohol content level of wine for application of excise taxes	141
Reduced rate of tax on mead and certain carbonated wines	141

Reduced excise tax rates on distilled spirits.....	142
Allow transfer of bonded spirits in bottles.....	142
Procedural provisions.....	142
Matching grants for return preparation programs for low-income taxpayers	142
Sense of the Senate regarding reinstating appropriate IRS funding level.....	143
Codification of the IRS Free File Program.....	143
Uniform tax treatment of attorney fees and court costs in connection with whistleblower awards.....	144
Improvement of the IRS whistleblower program	145
Revenue-dependent repeal prospective reporting provisions	145
Modification to user fee requirements for installment agreements	146
REITs	147
RICs	152
State and local tax implications	155
Impact of tax reform on accounting for income taxes	164
KPMG contacts	167

Individuals

The modified mark added an expiration date to the provisions contained in Title I (relating to tax reform for individuals) of the initial Chairman’s mark. As a result, except where noted, the changes described below would cease to apply after December 31, 2025. At that time, these tax provisions generally would revert to their pre-2018 form. Future legislation would be required to make the provisions effective beyond 2025.

Note that the expiration date does not apply to the provision requiring the use of “chained CPI” to index tax parameters.

KPMG observation

Some of the modifications made to the Chairman’s mark during the markup do not specify whether those provisions would be in Title I of the Finance Committee bill and whether they would be subject to sunset. Thus, given the absence of bill text, it is not certain whether these provisions would expire after 2025. We have used the most recent JCT table (JCX-59-17) as a guide to what effective dates may have been intended for some provisions.

Ordinary income tax rates—In general

The Finance Committee bill would modify the current income rate structure under which individuals are taxed, but not as drastically as the modifications contained in the House bill. The current rate structure has seven rates: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The Finance Committee bill would maintain the seven-rate structure, but would tax a taxpayer’s income at modified rates: 10%, 12%, 22%, 24%, 32%, 35%, and 38.5%.

The Finance Committee bill also includes special rules regarding the treatment of business income of individuals (e.g., individuals that conduct businesses through sole proprietorships, partnerships, and S corporations). See discussion of business rate below.

KPMG observation

The Finance Committee bill’s seven-rate structure does not propose to alter current law as significantly as the four-rate structure proposed in the House bill.

For married taxpayers filing a joint return (or for a surviving spouse): The 10% rate would apply to all income in excess of the standard deduction (see discussion below) up to \$19,050; the 12% rate would apply to all income over \$19,050, up to \$77,400; the 22% rate would apply to all income over \$77,400, up to \$140,000; the 24% rate would apply to all income over \$140,000, up to \$320,000; the 32% rate would apply to all income over

\$320,000, up to \$400,000; the 35% rate would apply to all income over \$400,000, up to \$1,000,000; the 38.5% rate would apply to all income over \$1,000,000.

For married taxpayers filing a separate return: The 10% rate would apply to all income in excess of the standard deduction up to \$9,525; the 12% rate would apply to all income over \$9,525, up to \$38,700; the 22% rate would apply to all income over \$38,700, up to \$70,000; the 24% rate would apply to all income over \$70,000, up to \$160,000; the 32% rate would apply to all income over \$160,000, up to \$200,000; the 35% rate would apply to all income over \$200,000, up to \$500,000; the 38.5% rate would apply to all income over \$500,000.

KPMG observation

The Finance Committee bill would eliminate the impact of the “marriage penalty” that affects some married individuals if both spouses have taxable income. Under current law an unmarried individual becomes subject to the 28% rate if his or her taxable income exceeds \$91,900 (2017). However, if that individual is married to someone with a similar amount of income, they would become subject to the 28% rate when their combined income exceeds \$153,100, which is less than double the threshold at which the 28% rate applies to unmarried individuals.

Under the Finance Committee bill, the marriage penalty would be eliminated for married individuals at all levels of income.

For taxpayers filing as head of household: The 10% rate would apply to all income in excess of the standard deduction up to \$13,600; the 12% rate would apply to all income over \$13,600, up to \$51,800; the 22% rate would apply to all income over \$51,800, up to \$70,000; the 24% rate would apply to all income over \$70,000, up to \$160,000; the 32% rate would apply to all income over \$160,000, up to \$200,000; the 35% rate would apply to all income over \$200,000, up to \$500,000; the 38.5% rate would apply to all income over \$500,000.

KPMG observation

Absent the possible mitigating impact of the increased standard deduction and the increased child and dependent tax credits, the Finance Committee bill would eliminate the tax benefit that exists under current law for a taxpayer filing as head of household versus filing as single. Under current law, the income thresholds for a head of household filer are more generous than for a single individual. The Finance Committee bill would eliminate the discrepancy in income thresholds between a head of household filer and a single individual for all income subject to the 24% rate and above.

For all other individual taxpayers: The 10% rate would apply to all income in excess of the standard deduction up to \$9,525; the 12% rate would apply to all income over \$9,525,

up to \$38,700; the 22% rate would apply to all income over \$38,700, up to \$70,000; the 24% rate would apply to all income over \$70,000, up to \$160,000; the 32% rate would apply to all income over \$160,000, up to \$200,000; the 35% rate would apply to all income over \$200,000, up to \$500,000; the 38.5% rate would apply to all income over \$500,000.

KPMG observation

Unlike the House bill, the Finance Committee bill does not include a phase-out of the lowest rate (12% in the House bill) for high income taxpayers.

The “kiddie tax”

Under current law, the net unearned income of a child is taxed at the higher of the parents’ tax rates or the child’s tax rates. The Finance Committee bill would simplify how the tax on a child’s net unearned income (kiddie tax) is calculated, by effectively applying the ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child.

JCT estimate

The JCT has estimated that the proposed rate structure (subject to 12/31/25 sunset) would decrease revenues by approximately \$1.2 trillion over a 10 year period.

Treatment of business income of individuals

Deduction of 17.4% for certain passthrough income

The Finance Committee bill includes a provision that generally would allow an individual taxpayer a deduction for 17.4% of the individual’s domestic qualified business income from a partnership, S corporation, or sole proprietorship. This deduction would sunset after 2025. The deduction generally would be limited to 50% of the sole proprietorship’s W-2 wages or 50% of the taxpayer’s allocable or pro rata share of W-2 wages of the partnership or S corporation. For this purpose, the taxpayer’s “W-2 wages” would equal the sum of wages subject to wage withholding, elective deferrals, and deferred compensation paid by the partnership, S corporation, or sole proprietorship during the tax year. The 50% of wages limitation does not apply in the case of a taxpayer with income of \$500,000 or less for married individuals filing jointly (\$250,000 for other individuals), with phase-out over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals).

With certain exceptions described below, an individual’s qualified business income for the tax year would be the net amount of domestic qualified items of income, gain, deduction, and loss (determined by taking into account only items included in the determination of taxable income) with respect to the taxpayer’s “qualified business.” If the amount of

qualified business income for a tax year were less than zero (i.e., is a loss), the loss would be treated as a loss from qualified businesses in the next tax year.

A qualified business generally would be any trade or business other than a “specified service trade or business.” A specified service trade or business is any trade or business activity involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees. However, the deduction may apply to income from a specified service trade or business if the taxpayer’s taxable income does not exceed \$500,000 (for married individuals filing jointly or \$250,000 for other individuals). Under the modified mark, this benefit is phased out over the next \$100,000 of taxable income for married individuals filing jointly (\$250,000 for other individuals).

Dividends from a real estate investment trust (other than any portion that is a capital gain dividend) would be qualified items of income, as are includable dividends from certain cooperatives. However, qualified business income would not include certain service related income paid by an S corporation or a partnership. Specifically, qualified business income would not include an amount paid to the taxpayer by an S corporation as reasonable compensation. Further, it would not include a payment by a partnership to a partner in exchange for services (regardless of whether that payment is characterized as a guaranteed payment or one made to a partner acting outside his or her partner capacity). Finally, qualified business income would not include certain investment related gain, deduction, or loss.

The proposal would be effective for tax years beginning after December 31, 2017. Under the modified mark, the 17.4% deduction would expire after December 31, 2025.

The JCT has estimated that the 17.4% deduction would decrease revenue by approximately \$362 billion over a 10-year period.

KPMG observation

The 17.4% deduction in the Finance Committee bill is not in the House bill. However, the 17.4% deduction would effectively reduce the tax rate applicable to domestic qualified business income. The House bill attempts to accomplish a similar result through an actual reduction in the applicable tax rate to business income of individuals from partnerships, S corporations, and sole proprietorships. The tax rate on income to which the House provision would apply would generally be 25% (although could be as low as 9% in certain situations). Under the House bill, the new rate generally would apply to all net business income from passive business activities and to the “capital percentage” of net business income from *active* business activities. Net business income is generally defined to include any wages, guaranteed payments, or non-partner capacity payments. The mark

also appears to relate solely to “domestic” qualified businesses, whereas the House bill does not appear to distinguish between foreign and domestic activities.

If the House bill and the Finance Committee bill provisions applied to identical amounts of income from partnerships, S corporations, and sole proprietorships, then taxpayers would generally pay less tax under the House bill than under the Finance Committee bill. In simplistic terms, under the House bill, an individual with \$100 of business income to which the 25% rate applied would pay just \$25 of tax on that income. If that same \$100 of income were qualified business income eligible for the 17.4% deduction included in the Finance Committee bill, then the net effect would be that the taxpayer would pay its ordinary tax rate on \$82.6 of income. If the taxpayer were in the highest rate bracket (which, under the Finance Committee bill, would be 38.5%), the taxpayer would pay almost \$32 of tax on the same income. Thus, if the amount of income subject to the House bill and the Finance Committee bill were identical, a taxpayer would pay almost \$7 more in tax on the same income under the Finance Committee bill.

However, there may be significant differences in the amount of income subject to the 17.4% deduction and the 25% rate that might amplify the impact of this issue. Moreover, limiting the available deduction to 50% of a taxpayer’s wage income allocable to qualified business income would reduce the net impact of the deduction.

The definition of “W-2 wages” in the mark will need to be clarified in the legislative language. The provision applies with respect to businesses operated as S corporations, partnerships, and sole proprietorships. Wages paid by an S corporation to its owners are W-2 wages, but an equivalent payment made by a partnership or a sole proprietorship to an owner are not. If wages (or their equivalents) paid to an owner of a business are intended to be included in W-2 wages, the definition will need to be expanded to encompass wage-like payments made to sole proprietors or partners (which may receive guaranteed payments or non-partner capacity payments). If wages paid to an owner of a business are *not* intended to be included as W-2 wages, then legislative language may be required with regard to W-2 wages paid to S corporation shareholders.

The modified mark significantly increased the income limitation with respect to the 17.4% deduction relating to a specified service trade or business. This change should significantly increase the number of taxpayers in a specified service trade or business that may take advantage of the deduction.

Under the modified mark, the 17.4% deduction would expire after eight years. In contrast, the corporate tax reduction in the Finance Committee bill would be permanent. If legislation following the Finance Committee’s approach were enacted, this difference may create a disadvantage to taxpayers doing business as a passthrough and should be considered by taxpayers in determining whether to conduct business in a corporate or passthrough form.

Loss limitation rules for taxpayers other than C corporations

The Finance Committee bill includes provisions that would expand certain limitations on losses for non-corporate taxpayers through 2025. Specifically, it would expand the application of sections 461(j) (relating to excess farm losses) and 469 (relating to passive activity losses).

Under current law, section 461(j) limits the use of an excess farm loss incurred by a taxpayer (other than a C corporation) that receives an applicable subsidy. Generally, an excess farm loss may be deducted, but only to the extent of the greater of: (i) \$300,000 (\$150,000 in the case of a married taxpayer filing a separate return); or (ii) the taxpayer's total net farm income for the five preceding tax years. Any excess loss is carried forward and treated as a deduction in the following tax year.

Current law also limits deductions and credits of individuals, estates, trusts, and closely held corporations from passive trade or business activities. For this purpose, a passive activity is a trade or business in which a taxpayer does not materially participate (as determined in accordance with the Reg. section 469 regulations).

Under current law, loss from a non-passive activity of a taxpayer generally may offset other sources of income (subject to other applicable rules). However, passive activity losses in excess of income from passive activity income may not be used to offset other income of the taxpayer. Instead, they are suspended and carried forward and treated as deductions from passive activities in the following tax year. Remaining suspended losses generally are allowed when a taxpayer disposes of the activity in a fully taxable transaction with an unrelated party.

The Finance Committee bill contains two provisions affecting the loss limitation rules. First, the Finance Committee bill would expand the limitation on excess farm losses. Although not explicitly stated, it appears that the expansion would eliminate a non-corporate taxpayer's ability to deduct an excess farm loss for a tax year in excess of \$500,000 for married individuals filing jointly or \$250,000 for other individuals.

Second, the Finance Committee bill contains a significant change to the treatment of non-passive losses of taxpayers other than C corporations. Under the Finance Committee bill, an excess business loss of such a taxpayer would not be allowed for the tax year. For purposes of this rule, an "excess business loss" for the tax year would be \$500,000 for married individuals filing jointly or \$250,000 for other individuals. Any excess business loss of the taxpayer would be treated as part of the taxpayer's net operating loss (NOL) and carried forward to subsequent tax years. These NOL carryforwards would be allowed for a tax year up to an amount equal to 90% of the taxpayer's taxable income (determined without regard to the NOL deduction).

In the case of a partnership or S corporation, the provision would apply at the partner or shareholder level. Thus, each partner or shareholder's share of the items of the entity would be taken into account in calculating the partner or shareholder's limitation. The provision would give the IRS authority to issue regulations to apply the rules to other passthrough entities.

The proposal would be effective for tax years beginning after December 31, 2017. According to the JCT revenue table, it is scheduled to sunset after 2025

The JCT has estimated that the proposed changes to the loss limitation rules would increase revenue by approximately \$137 billion over a 10 year period.

KPMG observation

The Finance Committee bill effectively would deny business deductions for taxpayers (other than C corporations) for any net business losses in excess of \$500,000 (or \$250,000 as relevant). This could be relevant for a taxpayer in the farming business that has a "very bad year" after several good years. Under current law, the taxpayer would be able to take into account income in its profitable years to increase the amount of its deduction from farming activities in the bad year.

Further, although it is not entirely clear, the provision in the Finance Committee bill could also affect a taxpayer that has previously suspended passive activity losses that are "freed up" as a result of a disposition of the passive activity. In such a case, those losses would be treated as non-passive losses in the year of the disposition. To the extent those losses exceed the threshold amount, they would not be available to the taxpayer in the year of disposition, but rather would become part of the taxpayer's NOL and carryforward to subsequent years.

Filing status, standard deductions, and personal exemptions

The Finance Committee bill would retain the filing statuses available to taxpayers under current law:

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Qualifying widow(er) with dependent child

The Finance Committee bill would impose due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household and a \$500 penalty each time a paid preparer fails to meet these requirements.

Similar to the House bill, the Finance Committee bill would significantly increase the standard deduction for all taxpayers for tax years beginning after December 31, 2017. Under current law, the standard deduction for 2018 is \$6,500 for a taxpayer filing as single or married filing separately, \$9,550 for a taxpayer filing as head of household, and \$13,000 for taxpayers filing as married filing jointly. Under the Finance Committee bill, the standard deduction in 2018 would be \$12,000 for a taxpayer filing as single or married filing separately, \$18,000 for a taxpayer filing as head of household, and \$24,000 for taxpayers filing as married filing jointly (and surviving spouses). These amounts would be adjusted for inflation for tax years beginning after December 31, 2018.

Unlike the House bill, the Finance Committee bill would not repeal the additional standard deduction for the elderly and the blind.

The proposed increase in the standard deduction, in conjunction with the repeal of many itemized deductions (discussed below), is intended to significantly reduce the number of taxpayers who itemize their deductions and thus to simplify the tax return preparation process. The increased standard deduction is also intended to compensate for the loss of the deduction for individual exemptions (\$4,150 for 2018), which would be repealed by the Finance Committee bill. This repeal would apply to the exemptions for the taxpayer, the taxpayer's spouse, and any dependents.

The JCT has estimated that the proposed modification to the standard deduction (subject to a 12/31/25 sunset) would decrease revenues by approximately \$737 billion over a 10 year period and the proposed repeal of deductions of personal exemptions (subject to a 12/31/25 sunset) would increase revenues by approximately \$1.22 trillion over a 10 year period.

KPMG observation

Under current law, for the 2018 tax year a married couple with two qualifying dependent children would have a standard deduction of \$13,000 and individual exemptions of \$16,600, for a combined deduction of \$29,600, \$5,600 greater than the deduction allowed under the Finance Committee bill. However, personal exemptions are subject to phase-outs under current law and the Finance Committee bill proposes an expanded child tax credit (discussed below) that could provide a greater tax benefit compared with current law. Additionally, the new rates and income thresholds proposed in the bill could potentially offset any loss of benefit from the repeal of the personal exemption.

New indexing method

The Finance Committee bill, like the House bill, would introduce a new method for indexing the tax rate thresholds, standard deduction amounts, and other amounts for inflation.

Under current law, annual inflation adjustments are made by reference to the consumer price index (CPI). The Finance Committee bill, however, would use “chained CPI,” which takes into account consumers’ preference for cheaper substitute goods during periods of inflation.

Chained CPI would generally result in smaller annual increases to indexed amounts and is estimated by JCT to increase revenues by approximately \$134 billion over a 10 year period.

The change to chained CPI for inflation indexing would be effective for tax years beginning after 2017 and would remain in effect after 2025 – it is not subject to the sunset provision that applies to other individual provisions.

Tax rates on capital gains and dividends

Similar to the House bill, the Finance Committee bill would keep in place the current system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, with higher rates for gains from collectibles and unrecaptured depreciation. The Finance Committee bill retains the same “breakpoints” for application of these rates as under current law, except the breakpoints would be adjusted for inflation after 2017. For 2018, the 15% breakpoint would be \$77,200 for married taxpayers filing jointly and \$38,600 for single filers. The 20% breakpoint would be \$479,000 for joint returns, and \$425,800 for single filers.

The Finance Committee bill also would leave in place the current 3.8% net investment income tax (consistent with the House bill).

Reform of the child tax and qualifying dependents credits

The Finance Committee bill would increase the child tax credit to \$2,000 per qualifying child from the current credit of \$1,000 per qualifying child, and would increase the age limit for a qualifying child by one year with the result that the credit can be claimed for any qualifying child under the age of 18. The Finance Committee bill would also provide a \$500 nonrefundable credit for qualifying dependents other than qualifying children.

KPMG observation

The House bill would provide a similar credit for qualifying dependents other than qualifying children. The \$300 credit proposed in the House bill would sunset in 2023, whereas the \$500 credit contained in the Finance Committee bill would sunset in 2025. Additionally, the Finance Committee bill does not include the temporary \$300 “family flexibility credit” proposed in the House bill.

Similar to current law, \$1,000 of the child tax credit would be refundable. The refundable portion would be indexed for inflation in future years. The income levels at which this credit is subject to phase-out would increase from \$110,000 to \$500,000 for joint filers, and from \$75,000 to \$500,000 for single filers (these thresholds are not indexed for inflation). Additionally, the earned income threshold for the refundable child tax credit would be lowered from \$3,000 under current law to \$2,500. This threshold would not be indexed for inflation.

The Finance Committee bill would require the taxpayer to provide a social security number (SSN) for each qualifying child for whom the credit is claimed on the tax return.

The JCT has estimated that the proposed modification to the child tax credit (subject to a 12/31/25 sunset) would decrease revenues by approximately \$584 billion over a 10 year period and the SSN requirement (subject to a 12/31/25 sunset) would increase revenues by approximately \$24 billion over a 10 year period.

Repeal of certain itemized deductions and income exclusions

Under current law, individual taxpayers may claim itemized deductions to decrease taxable income. The Finance Committee bill includes a number of provisions that would repeal or modify these deductions.

Combined, the JCT estimates that the following provisions related to certain taxes, home equity debt, casualty losses, tax preparation expenses, miscellaneous expenses, and the overall limitation on itemized deductions (all subject to a 12/31/25 sunset) would increase revenue by approximately \$978 billion over 10 years.

KPMG observation

The Finance Committee bill does not modify a number of itemized deductions and exclusions that were modified by the House bill such as medical expense deductions, contributions to medical savings accounts, alimony payments, adoption assistance programs and employer-provided dependent care assistance programs.

Deduction for taxes (including SALT) not paid or accrued in a trade or business

The Finance Committee bill would repeal the deduction for state and local income, sales and property taxes; war profits taxes; and excess profits taxes.

Under the Finance Committee bill, state, local and foreign property taxes and state and local sales taxes would be allowed as a deduction only when paid or accrued in carrying on a trade or business or an activity described in section 212 (relating to expenses for the production of income). Thus, only those deductions for state, local, and foreign property

taxes, and state and local sales taxes that are currently deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F of Form 1040 would be allowed.

The effective date would be for tax years beginning after December 31, 2017.

KPMG observation

While the annual deduction for real property taxes would not be available in relation to a principal residence used exclusively by the taxpayer, such a deduction would continue to be available for taxes attributable to rental property used in a trade or business.

Under the House bill, itemized deductions for state and local income taxes and sales taxes would be repealed. Itemized deductions for personal property taxes would be repealed (unless incurred in a trade or business or otherwise incurred for the production of income). The annual deduction for state and local real property taxes would be limited to \$10,000 (not indexed for inflation)—this cap would not apply if the taxes are incurred in carrying on a trade or business. In addition, foreign real property taxes, other than those incurred in a trade or business, would not be deductible.

Modify deduction for home mortgage interest

Under current law, qualified residence interest is allowed as an itemized deduction, subject to limitations. Qualified residence interest includes interest paid or accrued on debt incurred in acquiring, constructing, or substantially improving a taxpayer's residence ("acquisition indebtedness") and home equity indebtedness. Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the debt are used, but such interest is not deductible in computing alternative minimum taxable income.

Similar to the House bill, the Finance Committee bill would repeal the deduction for interest on home equity indebtedness. Unlike the House bill, however, the Finance Committee bill does not grandfather the deductibility of interest for current home equity indebtedness.

In contrast to the House bill, the Finance Committee bill would not reduce the amount of debt that can be treated as acquisition indebtedness from the current level of \$1 million or modify the treatment of interest attributable to mortgages secured by a second home (e.g. vacation homes).

The effective date would be for tax years beginning after December 31, 2017.

Increase percentage limit for charitable contributions of cash to public charities

The Finance Committee bill would increase the adjusted gross income limitation for charitable contributions of cash made by individuals to public charities and certain private foundations to 60% (from the current 50% limitation). This proposal would apply to contributions made in tax years beginning after December 31, 2017.

For the JCT estimate of revenue effects associated with this provision, see discussion of itemized deductions and income exclusions above.

KPMG observation

Although the Finance Committee bill would retain the charitable contribution deduction, even increasing the amount individual taxpayers may claim as a deduction in a single tax year, other proposed changes (e.g., lower tax rates and a higher standard deduction) might have an indirect impact on charitable giving.

The House bill includes the same provision. However, the House bill also includes another provision not proposed in the Finance Committee bill that would adjust the charitable mileage rate for inflation.

Modify deduction for personal casualty and theft losses

The Finance Committee bill would limit the deduction for personal casualty and theft losses to losses incurred in a federally-declared disaster.

The effective date would be for losses incurred in tax years beginning after December 31, 2017.

KPMG observation

The House bill would repeal the deduction for personal casualty and theft losses in all situations, with the exception of those incurred with respect to certain events specifically enumerated in the bill.

Repeal deduction for tax preparation expenses

Like the House bill, the Finance Committee bill would repeal the deduction for tax preparation expenses.

The effective date would be for tax years beginning after December 31, 2017.

Repeal of miscellaneous itemized deductions subject to the 2% floor

Under current law, individuals may claim itemized deductions for certain miscellaneous expenses. Some expenses (for example, investment fees, repayments of income, and safe deposit box rental fees) are not deductible unless, in aggregate, the expenses exceed 2% of the taxpayer's adjusted gross income. Unreimbursed business expenses incurred by an employee generally are deductible as an itemized deduction only to the extent the expenses exceed 2% of adjusted gross income. Other miscellaneous expenses that are subject to the 2% floor would include the taxpayer's share of deductible investment expenses from passthrough entities, and certain repayments including items of income received under a claim of right (if \$3,000 or less).

The Finance Committee bill would repeal all miscellaneous itemized deductions that are subject to the 2% floor.

KPMG observation

The House bill would introduce new section 262A that would disallow deductions for expenses attributable to the trade or business of performing services as an employee, except for above-the-line deductions allowable in determining adjusted gross income.

The effective date would be for tax years beginning after December 31, 2017.

Repeal of overall limitation on itemized deductions ("Pease" limitation)

Under current law, the total amount of allowable itemized deductions (with the exception of medical expenses, investment interest, and casualty, theft or gambling losses) is reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount (referred to as the "Pease" limitation).

Like the House bill, the Finance Committee bill would repeal the overall limitation on itemized deductions.

The effective date would be for tax years beginning after December 31, 2017.

Modification of exclusion of gain from sale of a principal residence

Current law permits individuals to exclude up to \$250,000 (\$500,000 if married filing jointly) of gain realized on the sale or exchange of a principal residence.

Like the House bill, the Finance Committee bill would extend the length of time a taxpayer must own and use a residence to qualify for the exclusion from two of the previous five

years to five of the previous eight years. In addition, the exclusion would be available only once every five years.

KPMG observation

The Finance Committee bill does not include a provision similar to the House proposal that would subject the exclusion to phase-out for individuals whose average modified AGI over the year of sale and the two preceding tax years exceeds \$250,000 (or \$500,000 for joint filers).

The provision would be effective for sales and exchanges after 2017 (subject to a 12/31/25 sunset) and is estimated by the JCT to increase revenues by approximately \$800 million over 10 years.

Repeal of exclusion for qualified moving expense reimbursements

Under current law, qualified moving expense reimbursements are excludible from an employee's gross income and from the employee's wages for employment tax purposes. Such expenses include amounts received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses which would be deductible as moving expenses if directly paid or incurred by the employee. Qualified moving expense reimbursements do not include amounts actually deducted by the individual. For members of the U.S. Armed Forces (and family members), moving and storage reimbursements and allowances for these expenses are excluded from gross income.

The Finance Committee bill would repeal the exclusion from gross income and wages for qualified moving expense reimbursements.

The effective date would be for tax years beginning after December 31, 2017.

The JCT estimates that this provision (subject to a 12/31/25 sunset) would increase revenues by approximately \$4.8 billion over 10 years. The estimate includes policy that retains the exclusion (under section 217(g)) related to members of the U.S. Armed Forces.

KPMG observation

The House bill would repeal the exclusion but would preserve the exclusion for qualified moving expense reimbursements for U.S. Armed Forces members (and family members).

KPMG observation

The JCT's revenue estimate reflects the retention of the exclusion for members of the U.S. Armed Forces although the Finance Committee bill does not explicitly provide for

such exclusion. However, the proposal to repeal the moving expense deduction (discussed immediately below) states that the rules with respect to the income exclusion for moving and storage expenses for members of the U.S. Armed Forces (and family members) would be retained.

Repeal of deduction for moving expenses

Under current law, individuals are permitted an above-the-line deduction for moving expenses paid or incurred in connection with starting work either as an employee or as a self-employed individual at a new principal place of work. The expenses are deductible only if specific distance and employment status requirements are met. In the case of certain members of the U.S. Armed Forces (and family members), the rules governing moving expenses also provide a special rule creating a targeted income exclusion for moving and storage expenses furnished in kind.

The Finance Committee bill would repeal the deduction for moving expenses. However, the targeted rules providing income exclusions to members of the U.S. Armed Forces (or their spouse or dependents) would be retained.

The House bill would generally repeal the deduction for moving expenses other than for members of the armed services.

The effective date would be for tax years beginning after December 31, 2017.

The JCT estimates that this provision (subject to a 12/31/25 sunset) would increase revenue by approximately \$7.6 billion over 10 years (note that the retention of the target income exclusion rules for military families appears to be included in the revenue analysis for the general exclusion rule described above).

KPMG observation

Repeal of the deduction for moving expenses would increase the cost of relocating employees. Businesses required to move employees to meet their business needs would face significantly higher costs after taking into account the gross-up for taxes.

Repeal of exclusion for qualified bicycle commuting reimbursement

Current law excludes up to \$20 a month in qualified bicycle commuting reimbursement from an employee's gross income. The Finance Committee bill would repeal this exclusion such that any reimbursement of this expense would be taxable.

The effective date would be tax years after December 31, 2017.

JCT estimates this provision (subject to a 12/31/25 sunset) would increase revenue by less than \$50 million over 10 years.

KPMG observation

There is no similar provision in the House bill.

Modification to the limitation on wagering losses

Under current law, losses sustained on wagering transactions are allowed as a deduction only to the extent of gains from wagering.

The Finance Committee bill would clarify that “losses from wagering transactions” includes any deduction otherwise allowable that is incurred in carrying on any wagering transaction. Thus, the limitation on losses from wagering transactions would apply to the actual costs of wagers incurred by an individual, and to other expenses incurred in connection with the conduct of the gambling activity. For instance, an individual’s otherwise deductible expenses in traveling to or from a casino are subject to the limitation.

The provision would be effective for tax years beginning after December 31, 2017.

The JCT estimates that this provision (subject to a 12/31/25 sunset) would increase revenue by approximately \$100 million over 10 years.

Estate, gift and generation-skipping transfer tax

The Finance Committee bill would double the basic exclusion amount from \$5,000,000 to \$10,000,000 (as indexed for inflation for years after 2011) per individual. This enhanced exclusion would apply to estates of decedents dying, generation-skipping transfers, and gifts made after 2017.

Unlike the House bill, the Finance Committee bill would not provide for future elimination of the estate and generation-skipping transfer taxes.

The JCT estimates this provision (subject to a 12/31/25 sunset) would decrease revenues by approximately \$83 billion over 10 years.

Other

Exclude income from the discharge of student debt

Similar to the House bill, the Finance Committee bill would exclude any income resulting from the discharge of student debt due to death or disability. The exclusion would apply to discharges of loans after December 31, 2017.

The JCT estimates that the proposal would decrease revenues by approximately \$100 million over a 10-year period.

The JCT table indicates that this provision is scheduled to sunset after 2025.

KPMG observation

This provision was added to the legislation by the modified mark. The provision was also in the House bill.

Modification of the deduction for certain educator expenses

Under current law, certain expenses of eligible educators may be taken as a deduction in determining adjusted gross income. The deduction may not exceed \$250 (for 2018) in expenses, indexed for inflation.

The Finance Committee bill would increase the deduction limit to \$500 for tax years beginning after December 31, 2017.

The JCT table indicates that the proposal would be effective for tax years beginning after 2017, but would sunset after 2025.

The JCT estimates that the proposal would decrease revenues by approximately \$1.5 billion through 2025.

KPMG observation

This provision was added to the legislation by the modified mark. The House bill takes a different approach to the provision – it would repeal the deduction for educator expenses.

Allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver's credit

The Finance Committee bill would increase the contribution limits by a designated beneficiary to ABLE accounts. The overall limit on contributions would remain the same

(\$14,000 for 2017). After the limits is reached, the designated beneficiary could contribution an additional amount up to the lesser of the Federal poverty line for a one-person household, or the individual's compensation for the tax year. The designated beneficiary could claim the saver's credit for contributions to their ABLE account.

The effective date would be for tax years beginning after the date of enactment. The modified mark states that this provision would sunset after December 31, 2025.

JCT estimates this provision would decrease revenues of less than \$50 million over 10 year.

KPMG observation

This provision was added to the legislation by the modified mark. A similar provision is not in the House bill.

Rollovers between qualified tuition programs and qualified ABLE programs

The mark would provide that amounts from qualified tuition programs under section 529 could be rollover over to an ABLE account without penalty provided that the ABLE account was owned by the designated beneficiary of the 529 account or a member of the designated beneficiary's family. The rollover would count towards the overall limitation on amounts that can be contributed to an ABLE account in a tax year. Amounts in excess of the limit would be included in income as provided under section 72.

The effective date would be for distributions after December 31, 2017 and the provision would sunset after December 31, 2025.

JCT estimates this provision would decrease revenues of less than \$50 million over 10 years.

KPMG observation

This provision added to the legislation by the modified mark. The House bill contains a similar provision.

Simplify filing requirements for individuals over 65 years of age

Currently, the standard individual income tax return forms are in the Form 1040 series, and include two simplified versions, the Form 1040A and the Form 1040EZ.

The Finance Committee bill would require the IRS to publish a simplified income tax return form (designated Form 1040SR) for use by persons who are age 65 or older by the close

of the tax year. The use of Form 1040SR would not be restricted based on the amount of taxable income to be shown on the return, or the fact that income to be reported includes social security benefits, distributions from qualified retirement plans, annuities or other deferred payment arrangements, interest and dividends, or capital gains and losses taken into account in determining adjusted net capital gain.

The proposal is effective for tax years beginning after December 31, 2018. Thus, the form would be available for 2019 tax returns to be filed by April 15, 2020. The JCT table, however, indicates that the proposal is scheduled to sunset after 2025.

The JCT has estimated that this proposal will have no revenue effect.

KPMG observation

This provision was added to the legislation by the modified mark. The House bill does not include a similar provision.

Expand definition of section 529 plan beneficiary

A qualified tuition program is a program which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses. Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs. Similar to the House bill, the Finance Committee bill would expand the definition of a designated beneficiary of a section 529 plan to include unborn children.

The modified mark states that this provision would sunset after December 31, 2025.

JCT estimates the proposal would decrease revenues by approximately \$100 million over 10 years.

KPMG observation

This provision was added to the legislation by the modified mark. A similar provision is in the House bill.

Relief for the Mississippi River Delta flood disaster area

The Finance Committee bill would provide tax relief relating to the “Mississippi River Delta flood disaster area”, a presidentially-declared disaster area resulting from the severe storms and flooding that occurred in Louisiana, Texas, and Mississippi during March, 2016 and in Louisiana during August, 2016.

The Finance Committee bill would provide an exception to the 10% early withdrawal tax related to a qualified Mississippi River Delta flooding distribution from a qualified retirement plan, a section 403(b) plan or an IRA. In addition, income attributable to such distribution would be included in income ratably over three years. Further, the amount of the distribution could be recontributed to an eligible retirement plan within three years. The total amount of distributions from all eligible retirement plans that could be treated as qualified Mississippi River Delta flooding distributions would be \$100,000 per individual.

The Finance Committee bill would also provide relief for personal casualty losses which arose in the Mississippi River Delta flood disaster area on or after March 1, 2016, where the loss was attributable to the severe storms and flooding giving rise to the Presidential disaster declaration. The losses would be deductible without regard to whether aggregate net losses exceed 10% of a taxpayer's adjusted gross income, as required under current law. However, to be deductible the losses must exceed \$500 per casualty. The proposal also would allow the losses to be claimed in addition to the standard deduction. The proposal would be effective on the date of enactment.

JCT has estimated the proposal would decrease revenues by approximately \$500 million over 10 years.

According to the JCT table, the proposal would be effective on date of enactment but would sunset after 2025.

KPMG observation

This provision was added to the legislation by the modified mark. The House bill does not include a similar proposal.

Exclusion from gross income of certain amounts received by wrongly incarcerated individuals

Under current law, a wrongfully incarcerated individual is not required to include in gross income any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the wrongful incarceration.

The Finance Committee bill would extend the waiver on the statute of limitations for filing a claim for credit or refund resulting from the exclusion for an additional year. Under the proposal, the claim for credit or refund must be filed before December 18, 2017.

The provision would be effective on the date of enactment. The JCT table indicates that the provision would sunset after 2025.

The JCT estimates the proposal would decrease revenues by less than \$50 million over a 10-year period.

KPMG observation

This provision was added to the legislation by the modified mark. The House bill does not contain a similar provision.

Combat zone tax benefits to Armed Forces in Sinai Peninsula of Egypt

The bill would grant combat zone tax benefits to Armed Forces members performing services in the Sinai Peninsula of Egypt, generally effective June 9, 2015. “Special pay” benefits include limited gross income and excise tax exclusions, surviving spouse benefits, and filing extensions.

The JCT revenue table indicates that this provision would sunset after 2025.

The JCT has estimated that the provision would lose less than \$50 million over a 10 year period.

KPMG observation

This provision was in the modified mark. There is no similar provision in the House bill.

Affordable Care Act—Healthcare

The Finance Committee bill contains a significant amendment to the Patient Protection and Affordable Care Act (“Affordable Care Act” or “ACA”). Specifically, the excise tax imposed on individuals who do not obtain minimum essential coverage would be reduced to zero.

However, no other ACA provisions are addressed in the Finance Committee bill, including provisions that have been the subject of individual bills such as the medical device excise tax and the annual health insurer fee.

Likewise, no other healthcare-specific provisions are in the Finance Committee bill, such as the modification to the medical expense deduction in the House bill or a cap on the exclusion of employer-provided health insurance from income and employment taxes that was discussed in the June 2016 Republican healthcare reform “blueprint.”

Reduce Affordable Care Act individual shared responsibility payment to zero

Under current law, the individual shared responsibility provision requires individuals to be covered by a health plan that provides at least minimum essential coverage, or be subject to a tax for failure to maintain the coverage. The tax is imposed for any month that an individual does not have minimum essential coverage, unless the individual qualifies for an exemption.

Under the proposal, the amount of the individual shared responsibility payment would be reduced to zero.

This provision would not be subject to the December 31, 2025 expiration date applicable to many other provisions affecting the taxation of individuals in this bill. The JCT estimates that reducing the individual shared responsibility payment to zero would increase revenues by approximately \$318.4 billion over 10 years.

KPMG observation

This proposal, because of its significance in the Affordable Care Act, is somewhat controversial and could impact efforts to build sufficient consensus to pass tax reform legislation. Efforts to repeal the individual mandate, along with a number of other ACA tax provisions, were unsuccessful earlier this year when Congressional Republicans attempted to pass healthcare reform legislation through the reconciliation process.

Alternative Minimum Tax repeal

The Finance Committee bill would sunset repeal of the individual alternative minimum tax (AMT) after 2025, but would not sunset the repeal of the corporate AMT.

Individual AMT

The Finance Committee bill would temporarily repeal the alternative minimum tax (AMT) for individuals. Repeal would be effective for tax years beginning after December 31, 2017, but would expire after December 31, 2025.

The JCT has estimated that the temporary repeal of AMT for individuals would decrease revenues by approximately \$769 billion over a 10-year period.

KPMG observation

Under current law, incentive stock options are treated as compensation at exercise for AMT purposes. The repeal of AMT would mean incentive stock options would only be subject to federal income tax when sold.

Corporate AMT

The Finance Committee Bill would repeal the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally could be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers would be refundable (a proration rule would apply with respect to short tax years). Any remaining AMT credits would be refundable in 2021.

The JCT has estimated that the repeal of the corporate AMT would reduce revenues by approximately \$40.3 billion over a 10-year period.

KPMG observation

In general

Repealing the corporate AMT would eliminate some of the complexity inherent in U.S. corporate taxation. For taxpayers with significant corporate AMT credit carryovers, the Finance Committee Bill would allow the full use of the credits to reduce or eliminate regular tax liability, and to obtain tax refunds to the extent the AMT credit carryovers exceed regular tax liability.

While the Finance Committee bill would repeal the AMT, it also would limit the NOL deduction for a given year to 90% and then, for tax years beginning after 2022, to 80% of taxable income, adding a limitation that currently exists only in the AMT area.

The proposal appears to be substantially the same as a proposal in the House Bill, although it would accelerate the refundable AMT credit carryover schedule by one year as compared to the House Bill.

Natural resources

The repeal of the corporate AMT also would eliminate the ability of taxpayers to use the optional 10-year write-off contained in Code section 59(e) to minimize the disparity between certain AMT adjustments and preference items, which makes a taxpayer's regular income tax closer to the alternative minimum tax. This change would affect intangible drilling and development costs for oil, gas, and geothermal wells (integrated oil corporations would still be required to capitalize 30% of their IDC allowable as a deduction ratably over the 60-month period beginning with the month in which the costs are paid or incurred) and the deduction for certain mine exploration and development expenditures. Under the AMT, mines were generally limited to cost depletion. However, for regular

income tax purposes, depletion on mines would remain the higher of cost or percentage depletion for the tax year. Independent oil and gas producers could still claim the higher of cost depletion or percentage depletion under section 613A.

Business—In general

Generally applicable C corporation provisions

The Finance Committee bill includes a permanent reduction in the corporate rate and the dividends received deduction, as well as changes to the net operating loss rules.

The bill, however, does not contain any provision corresponding to Section 3304 of the House bill (the provision that would repeal Code section 118, which currently provides that a corporation does not recognize income on its receipt of a capital contribution).

KPMG observation

The capital contribution repeal provision in the House bill is not limited to non-shareholder contributions. The House bill provision raises a number of apparently unintended and unexpected consequences, and could have a particularly destabilizing effect on workouts and efforts to rehabilitate troubled companies.

The Finance Committee bill also does not include the provision in the House bill that would repeal a taxpayer's ability to defer capital gain income on the sale of publicly traded securities by "rolling over" the proceeds of such sale to purchase interests in a "specialized small business investment corporation" (SSBIC). An SSBIC is a type of investment fund licensed by the U.S. Small Business Administration. While the program was repealed in 1996, certain grandfathered SSBICs still exist.

Reductions in corporate tax rate reduction and dividends received deduction

The Finance Committee bill would eliminate the progressive corporate tax rate structure, currently imposing a maximum U.S. corporate tax rate of 35%, and replace it with a flat tax rate of 20% (and make various corresponding changes throughout the Code). Further, it would eliminate the special U.S. corporate tax rate on personal service corporations (PSCs). The new rates would be effective for tax years beginning after 2018. In addition, the Finance Committee bill would lower the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%, effective for tax years beginning after 2018.

The Finance Committee bill also would repeal the alternative corporate tax on net capital gain (Code section 1201).

The JCT estimates that the rate reduction would decrease revenues by \$1.329 trillion over 10 years, while the dividends received deduction haircut would raise revenues by \$5.1 billion over the same period.

KPMG observation

This reduction is intended to make the U.S. corporate tax rate more competitive with the rates imposed by other countries. Consistent with the overall theme of the Finance Committee bill, this provision would lower tax rates in exchange for the elimination of certain tax benefits. The Finance Committee bill would apply the rate for tax years beginning after 2018, one year later than the House Bill, presumably due to revenue considerations.

The corporate rate reduction proposed by the Finance Committee bill could affect choice-of-entity decisions for some business entities. The proposed flat 20% corporate tax rate would differ from the effective rate for domestic business income of individuals earned through passthrough entities (after giving effect to the proposed 17.4% deduction discussed elsewhere in this document). As described in the individual rate discussion, certain income earned through active business activities of passthrough entities may still be taxed at the individual rates, for which the Finance Committee bill would provide a maximum tax rate of 38.5%.

The Finance Committee bill does not distinguish between investment income and active business income earned by corporations for purposes of applying the 20% tax rate. In addition, even though Chairman Hatch has been exploring integrating the corporate and individual income taxes, the Finance Committee bill does not contain a corporate integration proposal, meaning that corporate income subject to a 20% rate could be subject to a further tax in the hands of shareholders when distributed to them as dividends. However, see the discussion below regarding the dividends paid reporting and deduction provision possibly serving as a placeholder for a future integration proposal. Regardless, taxpayers should consider the impact of other changes to the Code proposed under the Finance Committee bill, and choice-of-entity decisions still would be affected by individual facts and circumstances.

The Finance Committee bill would reduce the personal service corporation tax rate to the general corporate tax rate. Generally, a professional service corporation is a C corporation (i) substantially all of the activities of which consist of the performance of services in fields such as accounting, health, law, etc., and (ii) of which employees performing services for the corporation in the identified fields own, directly or indirectly, substantially all of its stock. The Finance Committee bill thus differs from the House Bill, which would reduce the tax rate on PSCs to 25%, presumably to match the House Bill's 25% general business tax rate applicable to income generated by passthrough entities.

The Finance Committee bill proposed flat 20% corporate tax rate is higher than the 15% rate proposed by President Trump's tax plan, but matches the 20% rate proposed in the House Blueprint released in June 2016.

Modify net operating loss (NOL) deduction

The Finance Committee bill would limit the NOL deduction for a given year to 90% of taxable income, effective with respect to losses arising in tax years beginning after 2017. This limitation is similar to the current limitation of NOLs in the corporate alternative minimum tax regime (which would be repealed under the Bill). The Finance Committee bill would further limit the NOL deduction to 80% of taxable income in tax years beginning after 2022. Under a novel revenue-dependent repeal provision, the 80% limitation would revert to the 90% limitation for tax years beginning after 2025 if the amount of cumulative, aggregate, on-budget federal revenues from all sources from October 1, 2017 through September 30, 2026 exceeds a certain threshold.

The Finance Committee bill also would repeal NOL carrybacks, although it also would permit a new two-year carryback for certain farming losses, and it would retain present law for NOLs of property and casualty insurance companies. Current law generally provides a two-year carryback and twenty-year carry forward for NOLs, as well as certain carryback rules for specific categories of losses (e.g., "specified liability losses" may be carried back 10 years). The Finance Committee bill would provide for the indefinite carryforward of an NOL as opposed to the current 20-year carryforward. The Joint Committee of Taxation's description of the mark stated that "[c]arryovers to other years are adjusted to take account of the [90% of taxable income] limitation." At this point, the Senate Finance Committee has not yet released bill language, and it is unclear whether the language in the Joint Committee of Taxation's description was intended to refer to a provision that would annually increase NOL carryforwards by an interest factor, as in the House Bill.

The carryover provisions described above generally would be effective for NOLs arising in tax years beginning after December 31, 2017. The 80% of taxable income limitation would be effective in tax years beginning after 2022 and, as noted above, would revert to 90% of taxable income for tax years after 2025 if aggregate federal revenues from October 1, 2017 through September 30, 2026 exceed a specified amount.

The JCT has estimated that the proposal would increase revenue by approximately \$157.8 billion over 10 years.

KPMG observation

The Finance Committee bill does not appear to limit the three-year capital loss carryback allowed for corporations or impose a limitation on the utilization of capital loss carryovers.

The Finance Committee bill would require corporations to track NOLs arising in tax years beginning (1) before December 31, 2017, and (2) after December 31, 2017, separately, as only the latter category of NOLs would be subject to the 90% limitation or would be eligible for the indefinite carryover. In contrast, the 80% would apply with respect to tax years beginning after 2022, rather than to NOLs arising in tax years beginning after 2022. Accordingly, under the current language, it appears that NOLs arising in tax years beginning before December 31, 2017 would not be subject to the 90% limitation, but would be subject to the 80% limitation if carried forward to tax years beginning after 2022. It is not clear if the drafters intend this result or if the proposal will be altered to harmonize the 80% and 90% limitations.

Further, the potential reversion of the 80% limitation to the 90% limitation would present an unusual planning uncertainty. Absent unexpected circumstances, taxpayers could not expect to confidently predict whether the reversion would occur until well into 2026, when the relevant information regarding cumulative federal revenues and estimates for the remainder of FY 2026 would be known. This might affect modeling for cash tax expenses.

The changes to the NOL carryover provisions could have a significant effect on the financial statement treatment of loss carryovers incurred in future tax years, given that unused loss carryovers no longer would expire.

The NOL changes also would remove the counter-cyclical effect of loss carrybacks in that corporations generating losses due to a business downturn or due to large environmental or product liability payments no longer would be able to carry back losses to obtain refunds of taxes paid in prior years.

As noted above, the Finance Committee bill was released in conceptual language, and was not accompanied by proposed statutory language; thus, important detail is lacking. That said, it appears that the Finance Committee bill differs from the House Bill in several ways: (1) the House Bill applies the 90% limit to all NOLs carryovers after December 31, 2017 while the Finance Committee bill would apply the limit to NOLs *arising* after that date; (2) the House Bill does not contain the Finance Committee bill's 80% limitation; (3) the House Bill would apply a one-year carryback for certain casualty losses for small businesses and farming businesses while the Finance Committee bill would permit a two-year carryback for certain farming losses and would preserve the present law rules for NOLs of property and casualty insurance companies; (4) the House Bill's repeal of the carryback rules also would repeal carryback limitations for certain corporate equity reduction transactions and the Finance Committee bill does not address this; and (5) the House Bill provides a formula to increase NOLs by an interest factor over time, whereas it is unclear whether the Finance Committee bill contains a similar provision.

Dividends paid reporting and deduction

The provision would require corporations to report dividends paid during the tax year and the first 2½ months of the succeeding year. Consistent with current law, the provision would not permit corporations to deduct the payment of dividends in computing taxable income. Failure by a corporation to comply with the reporting requirement would subject the corporation to a penalty of \$1,000 for each day during which the failure continues, with the total penalty not to exceed \$250,000.

The provision also states that it “permits corporations to deduct 0% of dividends [paid] in computing taxable income subject to tax under section 11.”

The provision would be effective for tax years beginning after December 31, 2018. The JCT has estimated that the revenue impact of this proposal would be negligible.

KPMG observation

Although not clear, the reference to a “zero percent” dividends-paid deduction may be intended to facilitate, from a procedural perspective, the possible addition of a dividends paid deduction in a conference committee bill (assuming a formal conference is used to reconcile differences between House and Senate bills). It also is possible that an amendment providing a dividends paid deduction at other than a zero rate could be offered on the Senate floor. A dividends paid deduction is one of the potential ways to implement a “corporate integration” mechanism (*i.e.*, mitigating the effect of taxing corporate income at the entity level when recognized and again at the shareholder level when distributed).

Cost recovery

Modification of rules for expensing depreciable business assets

Under the Finance Committee bill, the section 179 expensing election would be modified to increase the maximum amount that could be deducted to \$1 million (up from \$500,000 under present law) (the “dollar limit”). The dollar limit would be reduced dollar-for-dollar to the extent the total cost of the section 179 property placed in service during the tax year exceeds \$2.5 million (up from \$2 million under present law) (the “phase-out amount”). These limits would be adjusted annually for inflation. The changes would be effective for tax years beginning after 2017.

In addition, the bill expands the availability of the expensing election to depreciable personal property used in connection with furnishing lodging – e.g., beds and other furniture for use in hotels and apartment buildings. It further expands the election to include roofs, HVAC property, fire protection and alarm systems, and security systems,

so long as these improvements are made to nonresidential real property and placed in service after the date the realty was first placed in service. These expansions to the definition of property eligible for the section 179 expensing election would also be effective for tax years beginning after 2017.

The JCT estimated that the provision would decrease revenues by approximately \$24 billion over 10 years.

KPMG observation

The bill would provide a significantly less generous expansion of the dollar limit and phase-out amount than provided by the House bill, which would allow a \$5 million dollar limit and a \$20 million phase-out amount. This is counterbalanced by adding more property to the definition of property eligible for the election and by making the expansion permanent.

Temporary 100% expensing for certain business assets

The Finance Committee bill would extend and modify the additional first-year depreciation deduction (“bonus depreciation”).

According to the Finance Committee bill, generally, the bonus depreciation percentage would be increased from 50% to 100% for property placed in service after September 27, 2017, and before 2023 (with an additional year for longer production period property and certain aircraft), as well as for specified plants planted or grafted after September 27, 2017, and before 2023.

The Finance Committee bill would generally keep the definition of qualified property the same as under current law, except that it would exclude any property used in providing certain utility services if the rates for furnishing those services are subject to ratemaking by a government entity or instrumentality or by a public utility commission.

KPMG observation

As in the House bill, the Finance Committee bill excludes from bonus-eligible qualified property any property used in trades or businesses that is not subject to the proposed limitation of net business interest expense under section 163(j). The bill also would expand the exclusion from the interest expense limitation to include property used in a farming business, but subject such property with a recovery period of 10 years or more to ADS (and by definition such property would not be qualified property eligible for bonus depreciation).

In addition, the Finance Committee bill creates a new category of qualified property that includes qualified film, television, and live theatrical productions, as defined under section

181(d) and (e), effective for productions placed in service after September 27, 2017, and before 2023. Under the bill, a production would be treated as placed in service on the date of its first commercial exhibition, broadcast, or live staged performance to an audience.

Consistent with the proposed repeal of AMT, the Finance Committee bill would repeal the ability of corporate taxpayers to treat AMT credits as refundable in lieu of claiming bonus depreciation, effective for tax years after 2017.

In the case of a taxpayer's first tax year ending after September 27, 2017, the Finance Committee bill would permit the taxpayer to elect to apply a 50% allowance in lieu of 100%.

The JCT estimated that the provision expanding qualified property to include qualified film, television and live theatrical productions would decrease revenues by \$1.7 billion over 10 years. The JCT estimated that all other aspects of the provision (with the December 31, 2022, sunset date) would decrease revenues by approximately \$61.3 billion over 10 years.

KPMG observation

The Finance Committee bill differs significantly from the House bill by not expanding the availability of bonus depreciation to non-original use property and not excluding property used in a real property trade or business or property subject to floor plan financing.

Modifications to depreciation limitations on luxury automobiles and personal use property

The Finance Committee bill would increase the depreciation limitations for passenger automobiles placed in service after 2017. If bonus depreciation is not claimed, allowable depreciation would be limited to \$10,000 in year one; \$16,000 in year two; \$9,600 in year three; and \$5,760 in all subsequent years. These limitations would be indexed for inflation for automobiles placed in service after 2018.

Computers and peripheral equipment placed in service after 2017 would no longer be considered "listed property," and thus would not be required to be depreciated using the straight-line method if their business use fell below 50%.

The JCT included the estimated revenue impact of this provision with that of the proposal to provide 100% bonus depreciation for five years.

Modifications of treatment of certain farm property

The Finance Committee bill would shorten the depreciation recovery period of certain machinery and equipment used in a farming business from seven to five years. To be

eligible for the shortened recovery period, the equipment must be placed in service after 2017 and the taxpayer must be the original user of the equipment.

Under current law, property with depreciation recovery periods of 10 years or less that is used in a farming business is required to be depreciated using the 150% declining balance method instead of the 200% declining balance method for which it would otherwise be eligible. The Finance Committee bill would repeal this requirement for property placed in service after 2017.

The Finance Committee bill also would require any farming trade or business that elects out of the interest deduction limitation to depreciate property with a recovery period of 10 years or more using ADS.

The JCT estimated the provision would decrease revenue by approximately \$1.1 billion over 10 years.

Applicable recovery period for real property

The Finance Committee bill would shorten to 25 years the depreciation recovery period for residential rental property and nonresidential real property from 27.5 years and 39 years, respectively. The ADS recovery period for residential rental property would be shortened from 40 years to 30 years.

The Finance Committee bill also would eliminate the special 15-year recovery period for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property; instead, it would provide a 10-year recovery period (20 years for ADS) for qualified improvement property, defined as certain interior improvements to nonresidential real property that are placed in service after the initial placed-in-service date of the realty, and a 25-year recovery period for restaurant building property (i.e., restaurant property that does not meet the definition of qualified improvement property).

In addition, section 179 expensing would be allowed only for qualified improvement property. Restaurant building property, which is currently eligible for expensing as qualified restaurant property, would no longer be eligible.

The Finance Committee bill also would require any real property trade or business that elects out of the interest deduction limitation to depreciate building property under ADS. As a result, a real property trade or business's nonresidential real property and residential rental property would be depreciated using the straight-line method over 30 years and its qualified improvement property would be depreciated using the straight-line method over 20 years.

These provisions would be effective for property placed in service after 2017.

The JCT estimated these provisions would decrease revenue by approximately \$11.1 billion over 10 years.

Requirement to capitalize section 174 research and experimental expenditures

Under the Finance Committee bill, amounts defined as research or experimental (R&E) under section 174 paid or incurred in tax years *beginning after December 31, 2025* would be required to be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified research or experimental expenditures which are attributable to research that is conducted outside of the United States (for this purpose, the term “United States” includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States) would be required to be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the tax year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

In the case of retired, abandoned, or disposed property with respect to which specified R & E expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule would be treated as a change in the taxpayer’s method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. This rule would be applied on a cutoff basis to R&E expenditures paid or incurred in tax years beginning after December 31, 2025 (hence there is no adjustment under section 481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2026).

As a result of the manager’s amendment, the Finance Committee bill also includes a reporting requirement for R&E expenditures in tax years beginning after 2024.

Notably, this provision could be repealed under the bill’s “revenue-dependent repeal” rules if total federal revenues for a certain period exceed a threshold amount. (See the discussion of revenue-dependent repeal.)

The JCT has estimated that this provision would raise approximately \$62.1 billion in the 10-year budget window (taking into account the delayed effective date).

KPMG observation

This proposal would substantially change the treatment of R&E and software development costs. Under current section 174, a taxpayer may currently expense R&E costs under section 174(a) or elect to treat R&E costs as deferred expenses under section

174(b), and such deferred expenses are allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Further, under current law an election to recover section 174 amounts over 10 years is available under section 59(e), which itself would be repealed with the proposed overall AMT repeal. Reg. section 1.174-2 provides a general definition of research and experimental expenditures, and it does not appear that this definition would change under the legislative proposal.

The IRS has had a long-standing rule of administrative convenience that permits taxpayers to treat the costs of developing software as deductible section 174 expenses, whether or not the particular software is patented or copyrighted or otherwise meets the requirements of section 174. See Rev. Proc. 2000-50 and its predecessor Rev. Proc. 69-21. The proposal would terminate this rule of convenience and require capitalization of software development expenses otherwise eligible for expensing under Rev. Proc. 2000-50. There are also a number of procedural issues concerning tax accounting method changes for section 174 and software development expenses that would need to be resolved under the revised statute.

Expensing certain citrus replanting costs

The Finance Committee bill would provide a special rule for replanting costs paid or incurred after the date of enactment, but not more than 10 years after such date, for citrus plants lost or damaged due to casualty. Under the rule, such costs could be deducted by a person other than the taxpayer if either (1) the taxpayer has an equity interest of at least 50% in the replanted citrus plants and the other person owns the remaining equity interest, or (2) such other person acquires all the taxpayer's equity interest in the land on which the citrus plants were located when damaged and replants on such land.

The JCT has estimated that this provision would lose less than \$50 million over a 10-year period.

KPMG observation

This provision was in the modified mark. It is not in the House bill.

Business-related deductions, exclusions, etc.

Limitation on the deduction of net business interest expense

The Finance Committee bill would amend section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income.

For this purpose, adjusted taxable income generally would be a business's taxable income computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the 17.4% deduction for certain passthrough income, and (4) the amount of any net operating loss deduction. The trade or business of performing services as an employee would not be treated as a trade or business for purposes of the limitation. The proposal would permit the Secretary to provide other adjustments to the computation of adjusted taxable income. The documents currently available with respect to the Finance Committee bill do not indicate if a business's taxable income may not be less than zero for purposes of the limitation. Business interest would be defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for tax purposes would be treated as "interest" for purposes of this proposal.

The provision would apply to all businesses, regardless of form, and any disallowance or excess limitation would generally be determined at the filer level (e.g., at the partnership level instead of the partner level). For a group of affiliated corporations that file a consolidated return, it applies at the consolidated tax return filing level. Any business interest disallowed would be carried forward indefinitely. Carryover amounts would be taken into account in the case of certain corporate acquisitions described in section 381 and would be subject to limitation under section 382.

Certain taxpayers could elect for the interest expense limitation not to apply, such as certain real estate businesses and (as a result of the modified mark) certain farming businesses; businesses making this election would be subject to certain cost recovery requirements. In addition, the limitation would not apply to certain regulated public utilities and (as a result of a clarification in the manager's amendment) certain electric cooperatives.

The proposed legislation would both prevent partners (or shareholders of an S corporation) from double counting adjusted taxable income of a partnership (or S corporation) for determining a partner's or shareholder's business interest limitation, and allow a partner or shareholder to use its distributive share of any excess amount of unused adjusted taxable income limitation of the partnership or S corporation in computing the partner's or shareholder's business interest limitation.

The adjusted taxable income of each partner (or shareholder) would be determined without regard to such partner's (or shareholder's) distributive share of the non-separately stated taxable income or loss of the partnership (or S corporation). Each partner or shareholder would receive its distributive share of any excess amount of the partnership's (or S corporation's) adjusted taxable income. Any such excess adjusted taxable income would be allocated in the same manner as non-separately stated income and loss.

The mark illustrates the double counting rule with the following example. ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates \$200 of

noninterest income. Its only expense is \$60 of business interest. Under the proposal the deduction for business interest is limited to 30% of adjusted taxable income, that is, $30\% \times \$200 = \60 . ABC deducts \$60 of business interest and reports ordinary business income of \$140. XYZ's distributive share of the ordinary business income of ABC is \$70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its business interest expense. XYZ has business interest expense of \$25. In the absence of a double counting rule, the \$70 of taxable income from XYZ's distributive share of ABC's income would permit XYZ to deduct up to an additional \$21 of interest ($30\% \times \$70 = \21), and XYZ's \$100 share of ABC's adjusted taxable income would generate \$51 of interest deductions, well in excess of the intended 30% limitation. If XYZ were a passthrough entity rather than a corporation, additional deductions might be available to its partners as well, and so on.

The double counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to the \$70 distributive share of the non-separately stated income of ABC. As a result it has adjusted taxable income of \$0. XYZ's deduction for business interest is limited to $30\% \times \$0 = \0 , resulting in a deduction disallowance of \$25.

The mark illustrates the excess amount distributive share mechanics with the following example. Assume the partnership described above had only \$40 of business interest and another \$20 of other deductible expenses. ABC has a limit on its interest deduction of \$60. The excess of this limit over the business interest of the partnership is $\$60 - \$40 = \$20$. The excess taxable income for ABC is $\$20 / \$60 \times \$200 = \66.67 . XYZ's distributive share of the excess taxable income from ABC partnership is \$33.33. XYZ's deduction for business interest is limited to 30% of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership ($30\% \times (\$0 + \$33.33) = \$10$). As a result of the rule, XYZ may deduct \$10 of business interest and has an interest deduction disallowance of \$15.

The net interest deduction limitation would not apply to certain regulated public utilities or any taxpayer with average gross receipts of \$15 million or less. Also, at the election of a taxpayer, the provision would not apply to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. A real property trade or business electing out of the limitation on the deduction for interest would have to use the alternative depreciation system (ADS) to depreciate its nonresidential real property, residential rental property, and qualified improvement property.

The proposal coordinates with the rules limiting interest deductions of members of international financial reporting groups. The Finance Committee bill would disallow interest deductions pursuant to whichever provision would deny a greater amount of interest deductions.

The provision would be effective for tax years beginning after 2017.

The JCT estimates the provision would increase revenues by approximately \$308 billion over 10 years.

KPMG observation

The House bill contains a similar proposal, but there are several notable differences. For example, unlike the House bill, the Finance Committee bill would determine adjusted taxable income by including certain deductions allocable to the trade or business such as depreciation, amortization, and depletion. In addition, any disallowed interest would be carried forward indefinitely (as opposed to the 5-year carryover in the House bill). The Finance Committee bill would permit a real property trade or business to elect out of the net interest disallowance regime but it would be required to use ADS to depreciate any nonresidential real property, residential real property, and qualified improvement property. The House bill contains a similar carve out for real property trades or businesses, but is mandatory rather than elective.

Under the Finance Committee bill, adjusted taxable income would be determined without regard to the 17.4% deduction for certain passthrough income. While this provision was not in the House bill, the 17.4% deduction was also not in the House bill. Accordingly, this definitional revision represents a conforming change that more closely aligns the Finance Committee bill with the House bill. The Finance Committee bill is otherwise similar to the House bill in most respects.

Under the Finance Committee bill, any net interest disallowance would apply at the filer level rather than the taxpayer level. Thus, the determination would be made at the partnership rather than the partner level. This would affect not only the determination of any interest disallowance, but also any excess amount (i.e., interest expense capacity) passed through from a partnership (or S corporation) to its partners (or in the case of an S corporation, its shareholders).

Special rules would allow a passthrough entity's unused interest limitation for the year to be used by its owners and to ensure that net income from the pass-through entity would not be double counted at the partner level. Significantly, the proposed rule would disallow business interest expense at the partnership level. It would be helpful if this result were illustrated with an example. If disallowance occurs at the partnership level, additional guidance would be needed to coordinate the treatment by partners and partnerships of any carryforward of disallowed business interest. For example, would the disallowance of interest at the partnership level create differences between the partnership's inside basis in its assets and the partner's basis in its partnership interest and what would happen to such disallowed interest in the event of transfers of partnership interests or upon the termination of the partnership?

The provision would apply only to *business* interest expense of the taxpayer. Nonbusiness interest, such as investment interest expense, would continue to be subject to the limitation on investment interest. In addition, fee payments that do not constitute interest would not be covered, nor would capitalized costs under Reg. section 1.446-5 (even though amortized as if OID).

The provision includes only taxable interest income in the computation of net business interest expense. Thus, investments in tax-free municipal bonds would not increase a taxpayer's interest expense capacity.

It is unclear how the proposed rule interacts with other interest disallowance and deferral provisions other than the limitation on deduction of interest by domestic corporations which are members of worldwide affiliated groups with excess domestic indebtedness. Because business interest is defined as any interest paid or accrued, it is unclear if the business interest amount would be computed taking into account interest the deduction for which is deferred or disallowed under some other provision of the Code. For example, if a corporation issues an applicable high yield discount obligation, the deduction for some or all of the original issue discount may be disallowed or deferred under section 163(e)(5). Other provisions that limit the deduction for interest paid or accrued on certain debt instruments include (but are not limited to) sections 163(f), 163(l), 163(m), and 279.

In addition, there appear to be no special rules for financial services entities. As a result, the determination of net business interest expense is unclear for a company like an insurer that generates significant interest income related to investments as an integral part of its active insurance business.

Finally, it should be noted that interest expense can occur as a result of repurchasing one's debt instrument at a premium. Under Reg. section 1.163-7(c), if a borrower were to repurchase its debt instrument for an amount in excess of its adjusted issue price, the repurchase premium is deductible as interest for the tax year in which the repurchase occurs, unless the deduction for the repurchase premium is disallowed under section 249 or the repurchase premium was the result of certain debt-for-debt exchanges.

Repeal deduction for income attributable to domestic production activities

Under the Finance Committee bill, the deduction for domestic production activities provided under section 199 would be repealed for tax years beginning after December 31, 2018.

JCT has estimated that repealing section 199 would increase revenues by approximately \$80.7 billion from 2018-2027.

KPMG observation

The original intent of the section 199 deduction was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While this proposed provision would eliminate the rate reduction created by section 199, a separate provision of the Finance Committee bill proposes a much larger overall corporate rate reduction, as discussed above.

The House bill also included a provision to repeal the deduction for income attributable to domestic production activities. However, the effective date of the repeal under that bill is tax years beginning after December 31, 2017. A separate provision of the House bill extended the section 199 deduction for income attributable to qualifying activities performed in Puerto Rico from tax years beginning before January 1, 2017 to tax years before January 1, 2018 (a one-year extension). The Finance Committee provision does not include any specific provisions related to Puerto Rico.

Limitation of deduction by employers of expenses for certain fringe benefits

The Finance Committee bill proposes to repeal deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer's trade or business. The Finance Committee bill would provide that no deduction is allowed for (1) an activity considered entertainment, amusement, or recreation, (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion of a facility used in connection with any of the above.

The Finance Committee bill generally would retain the 50% deduction for food and beverage expenses associated with a trade or business, effective for amounts paid or incurred after December 31, 2017.

However, as a result of a provision in the modified mark, the bill would eliminate the deduction for meals provided to employees for the convenience of the employer on the business premise, or through an employer-operated eating facility that qualifies as a de minimis fringe benefit. The manager's amendment indicates that this rule would not apply, however, until tax years beginning after 2025. Further, this change could be repealed under the bill's "revenue-dependent repeal" rules if total federal revenues for a certain period exceeded a threshold amount. (See the introduction for more on revenue-dependent repeal.)

The Finance Committee bill would disallow any deduction expenses associated with providing qualified transportation fringe and any expense to provide transportation for commuting between the employee's residence and place of employment (unless ensuring the safety of an employee).

JCT estimates this provision would increase revenue over 10 years by approximately \$22.9 billion for meals and entertainment expenses and \$17.4 billion for qualified transportation fringes.

KPMG observation

The provisions essentially provide the employer with a choice to include these amounts in employee taxable income and take a 100% tax deduction or exclude the amounts and take a lesser deduction.

There is a similar provision in the House bill.

Length of service award programs for bona fide public safety volunteers

The Finance Committee bill provides an increased aggregate amount of length of service awards that may accrue for a bona fide volunteer to any year of service to \$6,000 with an annual cost of living adjustment after the first year. If the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of services awards accruing to any year of service.

The effective date is for tax years beginning after December 31, 2017.

JCT estimates the provision would decrease revenues by \$500,000.

KPMG observation

This provision was in the modified mark.

Limits on like-kind exchange rules

The Finance Committee bill proposes to limit the like-kind exchange rules under Code section 1031 to exchanges of real property that is not held primarily for sale.

The limitation is proposed to apply to exchanges completed after December 31, 2017. A transition rule would be included under which the limitation would not apply to any exchange in which the taxpayer disposed of relinquished property, or received replacement property, on or before December 31, 2017.

The JCT has estimated that the proposal would increase revenues by approximately \$30.5 billion over a 10 year period.

KPMG observation

The proposed limitation on the like-kind exchange rules and the effective date of the limitation in the Finance Committee bill are identical to the changes proposed in the House bill.

The new rule would eliminate deferral under section 1031 for exchanges of tangible personal property and intangible property. For tangible personal property, the proposed allowance for full expensing in the Finance Committee bill may offset the negative impact of eliminating the gain deferral under section 1031. However, for personal property not subject to full expensing and intangible property, the proposed limitation to section 1031 would have an adverse impact.

Accounting methods

Certain special rules for tax year of inclusion

Under current law, an accrual method taxpayer generally is required to include an item in income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, which generally is the earliest of when the amount is received, due or earned. Certain exceptions exist to permit limited deferral of income for “advance payments” received prior to the amounts being earned, to the extent the advance payments are deferred for financial accounting purposes.

Under current law, interest income generally is recognized when received or accrued; however, the holder of a debt instrument with original issue discount (“OID”) generally accrues and includes the OID in gross income over the term of the instrument, regardless of when the stated interest (if any) is paid. Under existing authorities relating to OID, certain amounts related to credit card transactions, such as late-payment fees, cash-advance fees, and interchange fees, are deemed to create or increase the amount of OID on the pool of receivables to which the amounts relate.

Under the Finance Committee bill, a taxpayer would be required to recognize income no later than the tax year in which such income is taken into account as income in its applicable financial statements. An exception to this general rule would apply for long-term contract income to which section 460 applies.

Additionally, the proposal would codify the current deferral method of accounting for advance payment for goods and services provided by the IRS under Revenue Procedure 2004-34, which allows taxpayers to defer income from certain advance payments to the tax year following the year of receipt, to the extent deferred for financial statement purposes.

Finally, for holders of a debt instrument with OID, the proposal would require taxpayers to apply the revenue recognition rules under section 451 before applying the OID rules under section 1272. As a result, items included in income when received for financial statement purposes (e.g., late-payment and cash-advance fees) would generally be includible in income at such time in accordance with the general recognition principles under section 451.

The proposal would apply to tax years beginning after December 31, 2017, and application of these rules would be a change in the taxpayer's method of accounting for purposes of section 481.

JCT has estimated that the special rules for tax year of inclusion would increase revenues by approximately \$17.6 billion from 2018-2027.

KPMG observation

The special rules for tax year of inclusion provided for in the Finance Committee bill would cause an acceleration in the recognition of income for many taxpayers. For example, under the proposal, any unbilled receivables for partially performed services would be recognized to the extent the amounts are taken into income for financial statement purposes, whereas under current authority the income would be deferred until the earliest of when the services are complete or the taxpayer has the right to bill.

The proposal should also be considered in light of ASC 606, Revenue from Contracts with Customers, as companies may be required to change the timing of, and in many cases accelerate, recognition of revenue for financial statement purposes once the new standards become effective (generally 2018 for public companies, and 2019 for private companies) – which under the proposed provision in the Finance Committee bill could directly impact the timing of recognition for tax purposes.

The House bill did not include any proposals similar to the special rules for tax year of inclusion provided for in the Finance Committee bill.

Small business accounting

The Finance Committee bill includes several provisions (describe below) to reform and simplify small business accounting methods. These provisions would be effective for tax years beginning after December 31, 2017.

JCT estimates that the combined effect of these provisions would be a reduction in revenues by approximately \$27.6 billion over 10 years.

KPMG observation

Overall, these provisions would allow businesses greater access to the cash method of accounting, and expand exceptions to the UNICAP rules and the percentage of completion method.

The House bill also includes similar provisions but proposes a higher threshold of \$25 million for the gross receipts test compared to the proposed \$15 million threshold provided by the Finance Committee bill (described below).

Increase threshold for cash method of accounting

Under current law, with certain exceptions, a C corporation or partnership with a C corporation partner may use the cash method of accounting only if for each prior tax year its average annual gross receipts (based on the prior three tax years) do not exceed \$5 million. In addition, farm corporations and farm partnerships with C corporation partners may use the cash method of accounting if for each prior tax year its gross receipts do not exceed \$1 million (\$25 million for certain family farm corporations).

Under the Finance Committee bill, the threshold under the three-year average annual gross receipts test would be increased to \$15 million (indexed for inflation for tax years beginning after 2018), and would apply to all C corporations and partnerships with C corporation partners (other than tax shelters), including farming C corporations and farming partnerships. The \$25 million dollar gross receipts test threshold for family farming corporations would remain (and be indexed for inflation for tax years beginning after 2018), but the three-year average gross receipts test would apply. A change to or from the cash method of accounting as a result of the provision would be treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

Modify accounting for inventories

Under current law, businesses that are required to use an inventory method must also use the accrual method of accounting for tax purposes. An exception from the accrual method of accounting is provided for certain small businesses if for each prior tax year its average annual gross receipts (based on the prior three tax years) do not exceed \$1 million, and a second exception is provided for businesses in certain industries if for each prior tax year their average annual gross receipts (based on the prior three tax years) do not exceed \$10 million.

The Finance Committee bill would allow additional businesses with inventories to use the cash method by increasing this threshold to \$15 million. Under the provision, businesses with average annual gross receipts of \$15 million or less would be permitted to use the cash method of accounting even if the business has inventories. Under the provision, a

business with inventories that otherwise qualifies for and uses the cash method of accounting would be able to treat inventory as non-incidental materials and supplies or conform to its financial accounting treatment. A change to or from the cash method of accounting as a result of the provision would be treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

Increase exemption for capitalization and inclusion of certain expenses in inventory costs

Under current law, a business with \$10 million or less of average annual gross receipts for the prior three tax years is not subject to the uniform capitalization (UNICAP) rules with respect to personal property acquired for resale.

Under the Finance Committee bill, producers or resellers with average annual gross receipts for the prior three tax years of \$15 million or less would be fully exempt from the UNICAP rules. This exemption would apply to real and personal property for both resellers and manufacturers. A change in the treatment of section 263A costs as a result of the provision would be treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

Increase exceptions for accounting for long-term contracts

Under current law, the taxable income from a long-term contract generally is determined under the percentage-of-completion method. An exception to this requirement is provided for certain businesses with average annual gross receipts of \$10 million or less in the preceding three years. Under this exception, a business may use the completed contract method with respect to contracts that are expected to be completed within a two-year period.

Under the Finance Committee bill, the \$10 million average annual gross receipts exception to the percentage-of-completion method would be increased to \$15 million. Businesses that meet the increased average annual gross receipts test would be permitted to use the completed-contract method (or any other permissible exempt contract method). The provision would apply to contracts entered after December 31, 2017, in tax years ending after such date. A change in the taxpayer's method of accounting as a result of the provision would be applied on a cutoff basis for all similarly classified contracts; thus there would be no change, and no resulting section 481(a) adjustment, in the treatment of contracts entered into before January 1, 2018.

Business credits

Low-income housing credit

The Finance Committee bill would add new provisions to the low-income housing credit and rename the credit, as summarized below:

Recapture due to casualty

The Finance Committee bill would allow owners of qualified low-income buildings a period of up to 25 months from the date of a casualty loss, as established by the state housing agency, to restore qualified basis without triggering recapture. This provision is effective for casualty losses arising after the date of enactment.

KPMG observation

Generally, recapture can occur if a low-income unit is no longer habitable due to a casualty event. Since recapture is determined as of the end of each year in the compliance period, owners who suffer a casualty towards the end of the year will have up to 25 months from the date of the casualty to restore a low-income unit without triggering recapture in the year of the casualty.

Modification of right of first refusal

The Finance Committee bill would replace the present law right of first refusal for tenants, a resident management corporation, qualified nonprofit organization, or government agency to acquire a qualified low-income housing building after the end of the compliance period with a purchase option. This provision is effective for agreements entered into or amended after the date of enactment.

KPMG observation

This provision provides a purchase option in lieu of the present law right of first refusal for tenants, a resident management corporation, qualified nonprofit organization, or government agency, to acquire a qualified low-income housing building after the end of the compliance period for no less than the minimum purchase price equal to the outstanding principal indebtedness and taxes.

Qualified allocation plan modifications

The Finance Committee bill would provide that the criteria established by a housing credit agency for determining whether the development of a project in a qualified census tract contributes to a concerted community development plan is to take into account any factors the agency deems appropriate, including the extent to which the proposed plan (1) is geographically specific; (2) outlines a clear plan for implementation and goals for outcomes; (3) includes a strategy for applying for or obtaining commitments of public or private investment (or both) in nonhousing infrastructure, amenities, or services; and (4) demonstrates the need for community revitalization. This provision is effective for

allocations of housing credit dollar amounts made under qualified allocation plans adopted after December 31, 2017.

Also, the selection criteria to be used to determine housing priorities of the housing credit agency that are appropriate to local conditions under a qualified allocation plan may not include consideration of (1) any support or opposition with respect to the project from local or elected leaders, or (2) any local government contribution to the project, except to the extent such contribution is taken into account as part of a broader consideration of the project's ability to leverage outside funding sources, and is not prioritized over any other source of outside funding. This provision is effective for allocations of credit after 2017.

The Finance Committee bill further would require that qualified allocation plans include selection criteria that take into consideration of the affordable housing needs of individuals in the State who are members of Indian tribes. This provision would be effective for allocations of credit after 2017.

Finally, the bill would rename the "Low-Income Housing Tax Credit" the "Affordable Housing Tax Credit" effective as of the date of enactment.

KPMG observation

These modifications would clarify qualified allocation plan selection criteria in awarding allocations of low-income housing credits, including selection criteria for housing that serves the needs of Native Americans.

The Finance Committee bill also would retain the 9% low-income housing tax credit and the credit for projects financed by tax-exempt multifamily private activity bonds. By contrast, the House bill would repeal tax-exempt multifamily private activity bonds which would have in effect repealed the credit for projects financed by multifamily private activity bonds.

Modification of credit for clinical testing expenses for certain drugs for rare diseases or conditions

The Finance Committee bill would limit the "orphan drug credit" to 27.50% of qualified clinical testing expenses for the tax year, and would have reporting requirements similar to those under sections 48C and 48D.

The proposal would be effective for amounts paid or incurred in tax years beginning after 2017.

The JCT estimated that the proposal would increase revenue by approximately \$29.9 billion over 10 years. A repeal under the House bill was estimated as increasing revenue by \$54 billion over 10 years.

KPMG observation

Unlike the House bill (section 3401) that proposes to repeal the orphan drug credit, the Finance Committee bill would amend the credit by reducing the credit rate to 27.50% and imposing reporting requirements similar to sections 48C and 48D. Under sections 48C and 48D, the IRS established programs under which a taxpayer may submit an application for certification of qualifying projects, and the IRS, upon review of the application, allocate a specified amount of credits to qualifying projects. Both sections require the IRS to publicly disclose the identity of the applicant and the amount of the credit allocated to the applicant.

Repeal of deduction for certain unused business credits

The Finance Committee bill would repeal the deduction for unused business credits when they expire, effective for tax years beginning after 2017.

The JCT estimated that this proposal would have a negligible revenue effect over 10 years.

KPMG observation

The House bill (section 3405) also would repeal the deduction for certain unused business credits. However, unlike the House bill, the Finance Committee bill does not propose to repeal any general business credits.

Modification of rehabilitation credit

The Finance Committee bill would repeal the 10% credit for pre-1936 buildings and make a modification to the 20% credit for certified historic structures, generally for amounts paid or incurred after 2017. Specifically, as added in the manager's amendment, the "historic" credit would remain at 20% but must be claimed ratably over a five-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service.

A transition rule provides that, for buildings owned or leased at all times after 2017, the 24-month period for making qualified rehabilitation expenditures begins no later than 180 days after the date of enactment, and the modification is effective for such expenditures paid or incurred after the end of the tax year in which such 24-month period ends.

The JCT estimated that the provision would increase revenue by approximately \$3.1 billion over 10 years.

KPMG observation

The House bill would repeal the rehabilitation credit for both pre-1936 buildings and historic buildings.

Employer credit for paid family and medical leave

The Finance Committee bill would allow eligible employers to claim a credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (“FMLA”) if the rate of payment under the program is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

An eligible employer is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and that allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis. A qualifying employee means any employee who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60% of the compensation threshold for highly compensated employees.

The employer credit would generally be effective for wages paid in tax years after 2017 and before 2020.

KPMG observation

The Finance Committee bill would create a new general business credit for eligible employers. The proposal provides that vacation, personal, or other medical or sick leave is not eligible for this credit.

Miscellaneous Business Provisions*Qualified opportunity zones*

The Finance Committee bill would provide for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment held for at least 10 years in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in and holding at least 90% of its assets in qualified opportunity zone property. Qualified opportunity zone property includes any qualified opportunity zone stock, any qualified opportunity zone partnership interests, and any qualified opportunity zone business property.

The designation of a qualified opportunity zone is the same as the low-income community designation for the new markets tax credit. The certification of a qualified opportunity fund would be done by the Community Development Financial Institutions (CDFI) Fund, similar to the process for allocating the new markets tax credit.

Governors may submit nominations for a limited number of qualified opportunity zones to the Secretary for certification and designation and must consider areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

The creation of qualified opportunity funds would be effective on the date of enactment.

Alaskan Native Corporation payments and contributions to settlement trusts

The Finance Committee bill includes a proposal that would modify the tax treatment of Alaska Native Claims Settlement Act payments and contributions to settlement trusts. First, it would let Native Corporations assign certain payments to settlement trusts without recognizing gross income from the payments. Second, it would allow Native Corporations to elect annually to deduct contributions made to settlement trusts, subject to limitations. Finally, it would require that electing Native Corporation give the settlement trust a statement documenting details of contributions.

The first and third proposals would be effective for tax years beginning after 2016. The proposal for the deduction election would be available for tax years still open for refund claims, with a one-year limitations period waiver for a period expiring within one year of enactment.

The JCT has estimated that these changes would cost approximately \$100 million over a 10-year period.

KPMG observation

These proposed changes were in the modified mark. They are not in the House bill.

Aircraft management services

The Finance Committee bill would exempt certain payments made by aircraft owners to management companies (related to the management of private aircraft) from the section 4261 federal excise tax imposed on amounts paid for taxable transportation. These payments relate to maintenance and support of the owner's aircraft (such as storage,

maintenance, and fueling of the aircraft) or services related to flights on the owner's aircraft (such as hiring and training pilots and crew, flight planning, weather forecasting, and obtaining insurance). The exemption would apply to payments made by persons that lease aircraft, unless the lease is a "disqualified lease." Disqualified lease means a lease from a person providing aircraft management services for such aircraft if the lease term is 31 days or less.

The proposal would be effective for amounts paid after the date of enactment.

The JCT has estimated that the proposal would decrease revenues by less than \$50 million over 10 years.

KPMG observation

The Finance Committee bill would provide certainty on the issue of whether amounts paid to aircraft management service companies are taxable. In March 2012, the IRS issued a Chief Counsel Advice concluding amounts paid to aircraft management companies were generally subject to tax and the management company must collect the tax and pay it over to the government. The IRS began auditing aircraft management companies for this tax; however, it suspended assessments in May 2013 to develop further guidance. In 2017, the IRS decided not to pursue examination of this issue and conceded it in ongoing audits. No further guidance has been issued by the IRS to date.

Modify treatment of expenses in contingent fee cases

The Finance Committee bill, like the House bill, would deny attorneys deductions for expenses paid or incurred in relation to contingent-fee litigation until the time that the contingency is resolved, and instead treat them as amounts paid on behalf of clients (*i.e.*, akin to a loan or advance). As noted in the summary, courts have held that attorneys representing clients on a contingent fee basis may not currently deduct advances to or expenses paid on behalf of the clients until the contingency is resolved. However, under current case law in the Ninth Circuit, litigation costs such as court fees and witness expenses paid or incurred by an attorney under "gross fee" contingent fee contracts in some cases are immediately deductible when paid or incurred. This provision is therefore intended to create parity among taxpayers within and outside of the Ninth Circuit. The proposal would apply to expenses and costs paid or incurred in tax years beginning after the date of enactment.

The provision would apply to expenses and costs paid or incurred in tax years beginning after the date of enactment.

The JCT has estimated that the provision would raise approximately \$500 million over a 10-year period.

KPMG observation

This provision was in the modified mark.

Deny deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment or sexual abuse

Taxpayers are generally allowed a deduction under section 162 for ordinary and necessary expenses incurred in carrying on any trade or business. However, there are certain exceptions to the general rule. For example, there is no deduction allowed for certain lobbying and political expenditures, illegal bribes, kickbacks or other illegal payments, and any fine or similar penalty paid to a government for the violation of any law. The Finance Committee bill proposes an additional exception, under which deductions would no longer be available for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement. The provision would be effective for amounts paid or incurred after the date of enactment.

JCT has estimated that this provision would increase revenues by less than \$50 million over 10 years.

KPMG observation

This provision was in the modified mark.

Expand non-deductibility of certain fines and penalties

Fines and penalties paid to a government are currently non-deductible for Federal income tax purposes under section 162(f). The Finance Committee bill would further deny any otherwise deductible amounts paid or incurred to or at the direction of a governmental or specific nongovernmental entity for the violation or potential violation of any law. As under current law, certain exceptions would apply to payments established as restitution, remediation of property, or required for correction of noncompliance, as well as amounts paid or incurred as taxes due. Such exceptions would not apply to reimbursement of government investigative or litigation costs.

This provision would be effective for amounts paid or incurred after the date of enactment, not including amounts paid or incurred under any binding order or agreement entered into before such date.

JCT has estimated that this provision will increase revenues by \$100 million over 10 years.

KPMG observation

The provision in the Finance Committee bill (which was in the modified mark) would expand the definition of non-deductible fines and penalties to include certain payments for violations not made directly to the government. This provision is described as aiming to protect taxpayers, foster corporate accountability, and discourage future fraud and abuse. The House bill does not include any specific provisions related to the deductibility of fines and penalties.

Repeal deduction for local lobbying activities

Similar to the House bill, the Finance Committee bill would disallow the deduction for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments). The provision would be effective for amounts paid or incurred on or after the date of enactment.

JCT has estimated that this provision would raise approximately \$600 million over a 10-year period.

KPMG observation

This provision was in the manager's amendment. Only expenses associated with influencing legislation before local government bodies would be disallowed under both the Finance Committee bill and the House bill. Many lobbying expenses relate to currently non-deductible grassroots lobbying campaigns. Expenses associated with other common government affairs activities, such as monitoring legislation, attempts to influence rules and regulations, relationship building and reputational lobbying at the local government level would be considered deductible as ordinary and necessary business expenses. The House bill does not include any specific provisions related to the deductibility of local lobbying expenses before Indian tribal governments.

Compensation

The initial mark had included a provision changing the treatment of nonqualified deferred compensation. This provision was stricken from the bill as part of the modified mark.

Treatment of qualified equity grants

The Finance Committee bill would allow certain employees to defer the timing of compensation for certain stock options and restricted stock unit (RSU) plans for private companies. Under this provision, if "qualified stock" were granted to a "qualified

employee,” then the employee could make an election within 30 days of vesting to have the tax deferred. In such case, the employee would have income the earlier of:

- The first date the stock is transferable
- The date the employee becomes an “excluded employee”
- The first date the stock becomes readily tradable on an established securities market
- The date that is five years after vesting, or
- The date the employee revokes the election.

This election would only be allowed on “qualified stock,” which includes stock from the exercise of a stock option or the settlement of an RSU provided that the option or RSU was granted for the performance of services in a calendar year for which the corporation was an “eligible corporation.” In order to be an eligible corporation, the stock of the company could not be readily tradable on an established securities market during any previous year. In addition, the company must have a written plan during the year and not less than 80% of all employees who provide services in the U.S. could be granted options and RSUs with the same rights and privileges. Stock would not be qualified stock if the employee could sell or receive cash in lieu of stock from the corporation at the time of vesting.

The election could not be made by an “excludable employee,” which would include:

- An individual who has been a 1% owner at any time during the last 10 years
- An employee who has at any time been the CEO or CFO or an individual acting in such capacity
- A person who is a family member of an individual described in the above 2 bullets or
- A person who has been one of the four highest compensated officers of the corporation in the 10 preceding tax years.

The election would have to be made by the employee within 30 days of vesting. The employer would be required to provide the employee with notice of eligibility to make the election.

An election could not be made if the stock is readily tradable on an established securities market, or the company has purchased outstanding stock in the prior year (unless at least 25% is deferral stock and the individuals eligible to participate were determined on a reasonable basis).

A qualified employee would be allowed to make an election on qualified stock from a statutory option, but the option would no longer be treated as a statutory option.

The modified mark specifies that section 83 does not apply to RSUs, except for the section 83(i) election. RSUs are not eligible for section 83(b) elections.

The election would be valid only for income tax purposes and would change FICA and FUTA timing. In the tax year the income is ultimately required to be included in the employee's income as wages, the employer would be required to withhold at the highest individual income tax rate. The employer would be required to report the amount of the election deferral on the Form W-2 in both the year of the election and the year the deferral is required to be included in income. Also, the employer would be required to report annually on the Form W-2 the aggregate amount deferred under such an election.

The provision would be effective for options exercised, or RSUs settled, after December 31, 2017.

JCT estimates the proposal would decrease revenues by approximately \$1.2 billion over 10 years.

KPMG observation

This provision was in the modified mark.

Modification of limitation on excessive employee remuneration

The Finance Committee bill would repeal of the exceptions to the \$1 million deduction limitation for commissions and performance-based compensation. The bill would clarify that the definition of "covered employee" includes the principal executive officer, principal financial officer, and the three other highest paid employees. According to documents currently available, the bill would provide that once an employee is treated as a covered employee, the individual remains a covered employee for all future years. Further, the Finance Committee bill would expand the definition of a "publicly held corporation" to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The definition may include some corporations that are not publicly traded, such as large private C or S corporations.

The manager's amendment added a transition rule to the section 162(m) proposed changes. Under this rule, the expansion of section 162(m) would not apply to any remuneration under a written, binding contract in effect on November 2, 2017, which was not materially modified after this date.

The effective date of the proposal would be for tax years beginning after 2017.

JCT estimated the provision would increase revenues by approximately \$6.9 billion over 10 years.

KPMG observation

The House bill includes a similar proposal, but does not contain the transition rule in the Finance Committee bill.

The proposed elimination of the exception of performance-based compensation from the \$1 million dollar deduction limitation is a substantial change to the current rules. The performance-based exception, while complex, is an often-used exception to link compensation to performance and provide a greater deduction to a publicly held corporation. The proposed change to expand the definition of covered employee to include the principal financial officer in alignment with the definition used by the SEC has been a long discussed change as the differences in definitions generated some confusion. Expanding the definition to apply even after officers terminate would also be a major change. It is not clear how the deduction limitation would apply following a change in control.

Excise tax on excess tax-exempt organization executive compensation

This provision would impose a 20% excise tax on remuneration in excess of \$1 million and on excess parachute payments paid by an organization exempt from tax under section 501(a), an exempt farmer's cooperative (section 521(b)(1)), a political organization (section 527), or a federal, state, or local governmental entity with excludable income (section 115(1)), to any of its current or prior (beginning after December 31, 2016) five highest-paid employees.

Remuneration would include cash and other benefits paid in a medium other than cash. However, it would not include any designated Roth contribution (section 402A(c)) or amounts that are excludable from gross income. Remuneration would also include payments from certain related organizations, including organizations that control, or are controlled by, the tax-exempt organization. However, remuneration that is not deductible by reason of the \$1 million limit on deductible compensation (section 162(m)) is not taken into account for purposes of the proposal.

A "parachute payment" generally is defined as a payment contingent upon an employee's separation from employment if the aggregate present value of such payment equals or exceeds three times the employee's base amount. Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity (section 403(b)), or an eligible deferred compensation plan of a state or local government employer (section 457(b)). The 20% excise tax would be applied to the excess of the parachute payment over the portion of the base amount allocated to the payment.

The proposed legislation would apply to remuneration and parachute payments paid in tax years beginning after December 31, 2017.

JCT estimated the provision would increase revenues by approximately \$3.6 billion over 10 years.

KPMG observation

The Finance Committee bill provides rules for tax-exempt entities that are similar to section 162(m) limits on the deductibility of compensation paid by publicly traded corporations. However, the bill does not incorporate a transition rule similar to that included in the proposed changes to section 162(m), under which remuneration paid pursuant to a written binding contract in effect on November 2, 2017, would be excluded from the new rule, so long as the agreement is not later modified.

The bill also provides rules for tax-exempt entities that are similar to section 280G rules on excess parachute payments that may be applicable to taxable corporations. The proposed legislation related to “excess parachute payments” relies upon section 280G guidance for determining the “base amount” calculation.

The provision would impose the excise tax on the employer and related organizations, each sharing the liability in proportion to the compensation paid. As a result of the proposal’s broad definition of related organizations, it appears that a taxable organization could be subject to the excise tax.

The proposal would add an additional layer of complexity to the rules governing compensation paid by tax-exempt organizations. Currently, sections 4941 and 4958 impose excise taxes on the recipients of unreasonable or excess compensation paid by certain tax-exempt organizations. In addition, the inurement prohibition that applies to most tax-exempt organizations, the violation of which may result in loss of tax-exempt status, guards against the payment of unreasonable compensation. The proposal appears to not take into account some of these existing rules.

The House bill includes the same provision.

Retirement savings

The modified mark struck two retirement savings proposals that were in the initial mark: (1) the application of 10% early withdrawal tax to governmental section 457(b) plans, and (2) the elimination of catch-up contributions for high-wage employees.

Conformity of contribution limits for employer-sponsored retirement plans

The Finance Committee bill proposes a single aggregate limit to contributions for an employee in a section 457(b) plan, and section 401(k) plan, or section 403(b) plan of the

same employer. Section 401(k) and section 403(b) plan limits are already coordinated, but the proposal would require section 457(b) plans have similar coordination of plan limits.

The proposal would repeal additional elective deferrals and catch-up contributions under section 403(b) plans and governmental section 457(b) plans. The same catch up limits would apply to elective deferrals and catch-up contributions for section 401(k), section 403(b) and governmental section 457(b) plans.

The Finance Committee bill would repeal the special rule allowing employer contributions to a section 403(b) plan for up to five (5) years after termination of employment.

The effective date would be for plan years and tax years beginning after December 31, 2017.

JCT estimated the provision would increase revenues by approximately \$1.7 billion over 10 years.

KPMG observation

There is no similar provision in the House bill.

Repeal of special rule permitting recharacterization of IRA contributions

The Finance Committee bill would repeal the special rule that allows IRA contributions to one type of IRA to be recharacterized as a contribution to the other type of IRA. The proposal provides that a conversion contribution to a Roth IRA during a tax year could no longer be recharacterized as a contribution to a traditional IRA and unwinding the conversion. This provision would not prohibit a contribution to an IRA and a conversion to a Roth IRA.

The effective date would be for tax years beginning after December 31, 2017.

JCT estimates the provision would increase revenues by \$500 million over 10 years.

KPMG observation

This provision was in the modified mark.

Extended rollover period for the rollover of plan loan offset amounts

The Finance Committee bill would allow a qualified plan loan offset amount to be contributed to an eligible retirement plan as a rollover contribution to be extended from the current 60 days to the due date, including extensions, for filing the Federal income

tax return for the tax year the loan offset occurs. This extension would occur for a qualified plan loans offset amount distributed from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan solely because of a termination of the plan or a separation from service.

The effective date would be for tax years beginning after December 31, 2017.

JCT estimates the provision would have negligible revenue impact over 10 years.

KPMG observation

This provision was in the modified mark.

Individuals held harmless on improper levy on retirement plans

The Finance Committee bill would provide that if an amount were withdrawn from an IRA or employer-sponsored plan because of a levy and the amount were returned to the individual by the IRS, then the individual would have the option to contribute the amount returned with interest to the original IRA or to an employer-sponsored plan, or a different IRA to which a rollover would be permitted. The contribution would be allowed regardless of limits on IRA contributions or rollovers. The provision would only apply if the original levied amount was wrongful, or determined to be premature.

The contribution would have to be made by the due date, not including extensions, for the individual's income tax return for the year the IRS returns the previously levied amount. Any tax previously attributed to the amount distributed by reason of the levy is not to be assessed, if assessed is to be abated, and if collected is to be credited or refunded as an overpayment.

The effective date would be for levied amounts, and interest thereon, returned to individuals after December 31, 2017.

JCT estimates the proposal would have negligible impact on revenues.

KPMG observation

This provision was in the modified mark.

Passthrough entities

Tax gain on the sale of a partnership interest on look-through basis

The Finance Committee bill proposes to treat gain or loss on the sale of a partnership interest as effectively connected with a U.S. trade or business to the extent that the transferor of the interest would have had effectively connected gain or loss had the partnership sold its underlying assets.

In 1991, the IRS issued Rev. Rul. 91-32,¹ which much like the current proposal held that a foreign partner's capital gain or loss on the sale of a partnership interest is properly treated as effectively connected with a U.S. trade or business if and to the extent that the sale of the underlying assets by the partnership would have resulted in effectively connected income. Earlier this year, the Tax Court refused to follow the Revenue Ruling in determining that a foreign partner was not subject to U.S. tax on a sale of a partnership interest (to the extent the gain was not attributable to U.S. real property interests).²

The Finance Committee bill would adopt a look-through rule similar to that provided in section 897(g) to the sale of all partnership interests, not just those that hold U.S. real property interests. Specifically, the proposal would require that the gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange. For this purpose, the gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated items of income or loss.

The Finance Committee bill would also require the transferee of a partnership interest to withhold 10% of the amount realized on a sale or exchange of the interest unless the transferor certifies that it is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the Finance Committee bill would impose an obligation on the partnership to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

The JCT estimated that the provision would increase revenues by approximately \$3.8 billion over a 10-year period.

The changes would apply to tax years beginning after December 31, 2017.

¹ 1991-1 C.B. 107.

² Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (July 2017).

This provision was not in the House bill.

KPMG observation

This provision, which is not in the House bill, would impact foreign partners of partnerships engaged, directly or indirectly through one or more partnerships, in a U.S. trade or business, including partners in various fund structures. Partnerships, whether U.S. or foreign, that transfer such interests would be required to treat the appropriate amount of gain or loss as effectively connected to a U.S. trade or business and withhold on this amount with respect to any foreign partners.

Presumably the withholding provision would apply to all transfers of partnership interests, similar to withholding under section 1445, including those that are effected through a nonrecognition exchange, although this is unclear.

The proposed withholding regime differs from the withholding regime imposed under section 1445 with respect to the sale or exchange of an interest in a partnership that holds U.S. real property interests in that the only exception from 10% withholding is if the transferor certifies it is not a foreign corporation or nonresident alien individual. Presumably the failure to request certification from partnerships is due to the present existence of the section 1446 withholding regime which should cover those circumstances.

The provision also differs from the section 1445 regime in that an obligation is imposed on the partnership to withhold on distributions to the transferee in an amount that it failed to withhold. This puts an onus on the partnership to determine whether there was sufficient holding, and in some cases can raise questions as to what the amount realized on which withholding should have been done was (in cases of nonrecognition transfers, for example).

Finally, the reason for the requirement to allocate gains on a hypothetical sale of assets in the same manner as nonseparately stated income or loss is unclear. Partnerships may have different sharing ratios in operating income and gains from the sale of assets used in the trade or business. As such, using the ratio of nonseparately stated income to determine the amount of gain or loss on the sale of partnership interest that is effectively connected with a U.S. trade or business could yield different results from the effectively connected gains or losses allocated to a partner from an actual sale of assets by the partnership.

Modification of the definition of substantial built-in loss in the case of transfer of partnership interest

The Finance Committee bill proposes to modify the definition of a substantial built-in loss for purposes of section 743(d). Under current law, if the partnership has a substantial built-in loss in its property, it must decrease the adjusted basis of partnership property (with respect to the transferee partner) by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership (mandatory section 743(b) adjustment). The current rules determine whether there is a substantial built-in loss at the partnership level, comparing the partnership's adjusted basis in partnership property to the fair market value of its property. If the adjusted basis of all partnership property exceeds the fair market value by more than \$250,000 then the partnership is considered to have a substantial built-in loss and the mandatory section 743(b) adjustment is required to reduce the basis of the partnership assets with respect to the transferee. The purpose of the rule was to prevent the duplication of losses, once by the transferor partner upon the sale of his interest and a second time by the transferee upon the partnership's sale of the partnership property for other than small losses.

The Finance Committee bill would modify the definition of a substantial built-in loss to add a rule that focuses on a partner level determination, to further ensure that losses are not duplicated. The additional definition proposed to be added looks to whether the transfer of the interest has the effect of transferring a loss in excess of \$250,000 to the transferee, rather than just whether the partnership has an overall loss in its assets. Thus, even if the partnership would have an overall gain upon the sale of all of its assets, if the transferee would be allocated more than \$250,000 in losses, as a result of its share of gain or loss with respect to particular assets, a mandatory section 743(b) adjustment would be required. Specifically, the new rule would provide that a substantial built-in loss exists if the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical sale of all the partnership's assets in a fully taxable transaction for cash equal the assets' fair market value, immediately after the transfer of the partnership interest.

The JCT estimated that the provision would raise approximately \$0.5 billion over a 10-year period.

The changes would apply to tax years beginning after December 31, 2017.

This provision was not in the House bill.

KPMG observation

If enacted, the provision in the Finance Committee bill would create additional compliance issues, requiring a partnership to calculate whether it has a substantial built-in loss both at the partnership and the transferee partner level.

Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d)

The Finance Committee bill would modify section 704(d) to provide that a partner's distributive share of partnership items that are not deductible in determining the partnership's taxable income and are not properly chargeable to capital account (in other words, items that the partner would take into account separately on its tax return) is allowed only to the extent of the partner's tax basis in its partnership interest as of the end of the tax year in which the items are realized. A partnership's charitable contributions and foreign taxes paid or accrued would qualify as items that are not deductible by the partnership or properly chargeable to capital account. Therefore, section 704(d) as modified would apply to a partner's distributive share of those items. The manager's amendment clarifies that in the case of a charitable contribution of appreciated property, section 704(d) would not apply to the extent that the value of the property exceeds its tax basis.

The provision would be effective for tax years beginning after 2017. The JCT estimates that the provision would increase revenues by approximately \$1.2 billion over 10 years.

KPMG observation

While the mark notes that the IRS has taken the position that section 704(d) does not apply to a partner's distributive share of a partnership's charitable contributions (see Private Letter Ruling 8405084), it indicates that the exclusion of those items from the section 704(d) limitation is not appropriate.

The proposed modification appears to be generally consistent with rules that limit an S corporation shareholder's losses and deductions to its tax basis in the S corporation's stock and debt, taking the shareholder's pro rata share of the S corporation's charitable contributions and foreign taxes into account.

This provision was not in the House bill.

Partnership interest held in connection with the performance of services

The Finance Committee bill contains a provision that apparently is aimed at modifying the taxation of carried interests. According to the manager's amendment, the provision imposes "a three-year holding period requirement for qualification as long-term capital gain with respect to certain partnership interests received in connection with the performance of services."

The manager's amendment does not include an effective date for this provision.

The JCT estimated that this provision would raise approximately \$1.2 billion over a 10-year period.

KPMG observation

This provision was part of the manager's amendment that was approved at the end of the markup. No other details were provided elaborating on the terms of the proposal.

The House Bill provides for a similar three-year holding period requirement and also has been estimated as raising approximately \$1.2 billion over a 10-year period. Thus, it is possible that the Finance Committee bill might follow the approach described in the House bill.

S Corporations: Expansion of qualifying beneficiaries of ESBTs

For a corporation to qualify as an S corporation, ownership of the corporation's stock is limited to certain permitted shareholders. One type of trust permitted to own stock in an S corporation is an electing small business trust (an "ESBT"). The portion of an ESBT that owns stock in an S corporation is treated as a separate trust and the S corporation's income allocated to the ESBT is taxed to the trust itself (rather than to the trust's beneficiaries).

To qualify as an ESBT, a trust must meet certain requirements, including that a nonresident alien individual may not be a potential current beneficiary of an ESBT. This is consistent with a rule that precludes a nonresident alien individual from owning stock in an S corporation.

As a result of a provision in the modified mark, the Finance Committee bill would allow a nonresident alien individual to be a potential current beneficiary of an ESBT. The proposal would be effective on January 1, 2018.

The JCT estimated that this provision, together with the charitable deduction provision for ESBTs described below, would lose approximately \$300 million over a ten-year period.

KPMG observation

If enacted, this provision could expand the number of corporations that may elect S corporation status, as well as the ability of S corporation shareholders to engage in gift and estate tax planning. Prior proposed changes to law would have made the same change. However, other changes in the Finance Committee bill might make operating a business as an S corporation less desirable (and thus may only affect a limited number of corporations). The particular facts and circumstances would need to be taken into account in the choice-of-entity determination.

Charitable contribution deduction for electing small business trusts

As noted above, an ESBT may be a shareholder of an S corporation. If so, the ESBT's allocable share of the corporation's income is taxed to the trust; that income is taxed at the highest individual tax rate. Because an ESBT is a trust, the charitable contribution deduction applicable to trusts—rather than individuals—applies to the ESBT. A trust generally is allowed a deduction from gross income (without limitation) for amounts paid for a charitable purpose; no carryover of excess deductions is allowed. In contrast, an individual's charitable contribution deduction is limited to certain percentages of adjusted gross income, with a carryforward of amounts in excess of the limitation.

The modified mark would amend current law to provide that the charitable contribution deduction allowed for the portion of an ESBT holding S corporation stock would be determined under the rules applicable to individuals, rather than those applicable to trusts. The proposal would apply to tax years beginning after December 31, 2017.

Other proposals relevant to passthrough entities

See discussion of “treatment of business income of individuals” for provisions relating to (1) a 17.4% deduction for certain passthrough income of owners who are individuals and (2) a limitation on losses for taxpayers other than corporations.

The House bill provided for the repeal of technical terminations of partnerships. The Finance Committee bill does not contain a similar provision.

Banks and financial institutions

Deduction limits for FDIC premiums

A proposed provision would limit the amount certain financial institutions could deduct for premiums paid pursuant to an assessment by the Federal Deposit Insurance Corporation (FDIC) to support the deposit insurance fund. The proposed limitation would apply only if the “total consolidated assets” of a financial institution (determined as of the close of the relevant tax year) exceed \$10 billion. A special aggregation rule would apply for purposes of calculating “total consolidated assets” within an “expanded affiliated group” of related entities.

Under the proposed rule, the limitation would be equal to the ratio (not to exceed 100%) that (1) “total consolidated assets” in excess of \$10 billion bears to (2) \$40 billion. As a result, for financial institutions with “total consolidated assets” in excess of \$50 billion, no deduction for such premiums could be claimed.

The provision would be effective for tax years beginning after December 31, 2017, and the JCT estimates the limitation on deduction for FDIC premiums would increase revenues by approximately \$14.5 billion over 10 years.

KPMG observation

A similar provision was in the House bill.

Repeal of advance refunding bonds

The Finance Committee bill would subject to tax the interest on advance refunding bonds – bonds used to pay principal, interest, or redemption price on a prior bond issue. Advance refunding bonds are those refunding bonds that are issued *more* than 90 days before the redemption of the refunded bonds. In general, governmental bonds and qualified 501(c)(3) bonds may be advance refunded only one time, while private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded at all. The provision would apply to bonds issued after December 31, 2017.

The JCT estimates the repeal of advance refunding bonds would increase revenues by approximately \$16.8 billion over 10 years.

KPMG observation

Under current law, the advance refunding rules permit an issuer to refinance a prior bond issue to achieve debt service savings even though that issue might not be callable for more than 90 days from the issuance of the refunding bonds. This proposal would likely increase the cost of debt for organizations eligible to advance refund prior bond issues, such as section 501(c)(3) organizations.

Advance refunding bonds issued on or before December 31, 2017, would not be affected by these changes. Notably, the proposal does not appear to include a transition rule that would permit the advance refunding of bonds issued before January 1, 2018. In addition, interest on refunding bonds issued *within* 90 days of the redemption of the refunded bond (i.e., not *advance* refunding bonds) would remain tax-exempt.

An identical provision is in the House bill. However, the Finance Committee bill does not include a provision similar to the provision in the House bill that would eliminate the tax-exempt treatment of interest received from “qualified bonds.”

Cost basis of specified securities determined without regard to identification

The proposal would change the way in which taxpayers may determine the cost basis of specified securities. A specific security includes any stock of a corporation (including stock of a regulated investment company or “RIC”), as well as any debt, commodity or

contract or derivative with respect to such commodity (to the extent required by Treasury), and other financial instrument (also to the extent required by Treasury).

Current law generally requires a taxpayer that sells only a portion of its holdings in a specified security which it has acquired in multiple lots over different dates or at different prices, to use a first-in first-out (“FIFO”) method in determining which lot is sold. However, if the taxpayer specifically identifies one or more lots, those lots are treated as the lots that are sold. In addition, Treasury regulations permit a taxpayer that owns shares in a RIC to use an average-cost-basis method to determine the basis of RIC shares sold.

Current law also requires a broker to report to the IRS a customer’s adjusted basis in a specified security that the customer has sold, as well as whether any gain or loss from such sale is long-term or short-term.

The proposal requires the cost of any specified security sold, exchanged or otherwise disposed of on or after January 1, 2018 to be determined on a FIFO basis, except to the extent that the average basis method is otherwise allowed with respect to stock of a RIC. As finally approved by the Senate Finance Committee, the proposal also exempts RICs from the FIFO rule. Given that RIC stock was already exempt from the repeal of the specific identification method under the proposal, the addition of a RIC exemption appears to apply to securities held by RICs and not just RIC stock. Thus, the proposal eliminates the ability of taxpayers other than RICs to use the specific identification method.

With the exemption for RICs from the FIFO rule, the JCT estimates that this change as approved by the Senate Finance Committee would increase revenues by \$2.4 billion over 10 years. Without the exemption for RICs from the FIFO rule, this change would increase revenues by \$2.7 billion over 10 years. This change is not included as part of the Ways and Means Bill.

KPMG observation

This change may be unfavorable for taxpayers who currently use the specific identification method, as those taxpayers would no longer have the ability to specifically identify securities in order to minimize taxable gain on a sale. Instead, taxpayers other than RICs would be limited to using the FIFO method, except for RIC stock with respect to which taxpayers may still elect to use an average-cost-basis method. Preventing taxpayers from using a specific identification method would mean that taxpayers (1) may have gain on a sale that they may not have had if they could have identified higher basis shares as being sold, (2) may have long-term loss on a sale which may have been short-term loss if they could have identified shares held for a shorter timeframe as being sold, or (3) may have loss on a sale subject to the wash sales rules instead of gain on the sale if lower basis shares were specifically identified.

In addition, brokers have invested substantial time and money into their cost basis reporting systems, including to accommodate the specific identification method. While the proposal's elimination of the specific identification method ostensibly simplifies cost basis reporting, it would require efforts by brokers to "turn off" specific identification for "specified securities" as an available method to determine cost basis and to communicate this change to clients. A potential complicating factor worth noting is that not all securities are treated as "specified securities" under current IRS regulations, including debt instruments subject to section 1272(a)(6), short-term obligations described in section 1272(a)(2)(C) and certain derivatives.

Insurance

The Finance Committee bill proposes several changes that would affect the taxation of the insurance industry.

Net operations loss deductions of life insurance companies

The net operation loss provision would alter the operations loss carryover and carryback periods for life insurance companies (currently carried back three years and forward 15) by striking Code sections 810 and 844 and conforming these periods to those of other corporations.

The Finance Committee bill also modifies the carryover and carryback rules for all corporations (other than nonlife insurance companies). All net operating losses are repealed and taxpayers are allowed to carry net operating losses forward indefinitely (except for a special two year carryback in the case of certain losses incurred in the trade or business of farming). Under the proposed provision, taxpayers' ability to deduct a net operating loss carryover (or carryback, under the aforementioned casualty loss provision) would be limited to 90% of the taxpayer's taxable income for the year. The modified mark would further limit the net operating loss deduction to 80% of taxable income (determined without regard to the deduction). The manager's amendment changed the date to limit the net operating loss deduction to 80% of taxable income in tax years beginning after December 31, 2022.

These provisions would be effective for losses arising in tax years beginning after 2017 other than the 80% limitation as described above which begins in tax years after 2022. The revenue effect is included in the JCT estimate for the broader modification of the net operating loss above.

KPMG observation

This proposal would put life insurance companies on the same loss carryback and carryforward schedule as other corporations. The repeal of nearly all carrybacks could

have a substantial impact on a life company's deferred tax asset admissibility computation for statutory accounting purposes. The first part of the admissibility test under SSAP 101 would no longer be applicable for ordinary deferred tax assets since it allows insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

The limitation of a life insurance company's operating loss deduction to 90% of the company's taxable income would conform to current law regarding the utilization of losses to compute alternative minimum tax. The 80% limitation beginning in tax years after 2022 would also be applicable to life insurance companies.

The House bill includes a similar provision; however the 80% limitation in tax years beginning after 2022 is specific to the Finance Committee bill.

Net operations loss deductions of property and casualty insurance companies

The Finance Committee bill would preserve present law for net operating losses of property and casualty companies. Under the modification, which would be the same as current law, net operating losses of property and casualty companies may be carried back two years and carried forward 20 years to offset 100% taxable income in such years.

KPMG observation

This proposal would put life insurance companies and non-life insurance companies on different loss carryback and carryforward schedules. Unlike the impact on the life insurance industry, a non-life insurance's company's deferred tax asset admissibility computation for statutory accounting purposes would not change. The first part of the admissibility test under SSAP 101 would still be applicable and would allow the same computations as under current law.

The House bill does not include a similar provision that preserves current law treatment for non-life companies.

Repeal small life insurance company deduction

Code section 806 allows life insurance companies to currently deduct 60% of their first \$3 million of life insurance-related income. The deduction is phased out for companies with income between \$3 million and \$15 million. In addition, the deduction is not available to life insurance companies with assets of at least \$500 million.

The proposed provision would repeal the Code section 806 special deduction for small life insurance companies.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would increase revenues by approximately \$0.2B over 10 years.

KPMG observation

This proposal is described as eliminating special treatment for a segment of the insurance industry in which “the risk distribution benefits of risk pooling are the weakest.” The proposal would not eliminate a similar benefit for small property and casualty insurers. This proposal appears identical to one in the House bill.

Repeal Code section 807(f) spread—Adjustment for change in computing reserves

Under 807(f), taxpayers are currently required to make adjustments to taxable income when they change a tax accounting method, so that the accounting method change does not result in an omission or duplication of income or expense. For taxpayers other than life insurance companies, an adjustment that reduces taxable income generally is taken into account in the tax year during which the accounting method change occurs, while an adjustment that increases taxable income may be taken into account over the course of four tax years, beginning with the tax year during which the accounting method change occurs.

The proposed provision would repeal the special 10-year period for adjustments to take into account changes in a life insurance company’s basis for computing reserves. The general rule for tax accounting method adjustments would apply to changes in computing reserves by life insurance companies, generally ratably over a four-year period, instead of over a 10-year period.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would increase revenues by approximately \$1.3 billion over 10 years.

KPMG observation

This proposal would put life reserve computation changes on the one-year or four-year spread rules applicable to general changes in methods of accounting. The proposal appears to provide that changes in life insurance reserve basis would continue to be an automatic adjustment and not require prior approval for such changes.

The proposal is identical to one included in the House bill.

Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts

Previous rules enacted in 1959 included a rule that half of a life insurer's operating income was taxed only when the company distributed it, and a "policyholders surplus account" kept track of the untaxed income. In 1984, this deferral of taxable income was repealed, although existing policyholders' surplus account balances remained untaxed until they were distributed. Legislation enacted in 2004 provided a two-year holiday that permitted tax-free distributions of these balances during 2005 and 2006. During this period, most companies eliminated or significantly reduced their balances.

The proposed provision would repeal the rules for distributions from pre-1984 policyholders' surplus accounts.

The provision would generally be effective for tax years beginning after 2017, and any remaining balances would be subject to tax payable ratably over the first eight tax years beginning after December 31, 2017.

The JCT has estimated that the provision would increase revenues by less than \$50 million over 10 years.

KPMG observation

This proposal was one suggested by the American Bar Association Tax Section Insurance Companies Committee and is not expected to raise significant revenue.

This proposal is identical to one in the House bill.

Modify proration rules for property and casualty (P&C) insurance companies

A proration rule applies to P&C companies. In calculating the deductible amount of its reserve for losses incurred, a P&C company must reduce the amount of losses incurred by 15% of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received, and (3) the increase for the tax year in the cash value of life insurance, endowment, or annuity contracts the company owns. The proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

The proposed provision replaces the 15% reduction under present law with a reduction equal to 5.25% divided by the top corporate tax rate. For 2018, the top corporate tax rate is 35%, and the percentage reduction is 15%. For 2019 and thereafter, the corporate tax rate is 20% and the percentage reduction is 26.25% under the proration rule for P&C

companies. The proration percentage will be automatically adjusted in the future if the top corporate tax rate is changed, so that the product of the proration percentage and the top corporate tax rate always equals 5.25%.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would increase revenues by approximately \$2.2 billion over 10 years.

KPMG observation

The JCT description states that the increase in the haircut within the provision would keep the reduction in the reserve deduction consistent with current law by adjusting the rate proportionally to the decrease in the corporate tax rate. That rationale may not be consistent with the provision's purpose under current law, which is to measure the amount of tax-exempt income credited to reserves (estimated at 15%) in order to eliminate a double benefit. Although the reduction is significant, a rate tied to the product of the proration percentage and top corporate tax rate may still be preferable overall to many insurers as the calculated rate facilitates predictability of after-tax rates of return on tax-exempt bonds and compares those rates to other investments.

With a permanent corporate tax rate of 20%, both the House bill and the Finance Committee bill would result in a proration rate of 26.25%. However, in contrast to the House bill (which has a fixed rate of 26.25%), the Finance Committee bill's proration rate would automatically adjust based on changes to the corporate tax rate.

Repeal elective deduction and related special estimated tax payment rules

Under current law, insurance companies may elect to claim a deduction equal to the difference between the amount of reserves computed on a discounted basis and the amount computed on an undiscounted basis. Companies which make this election are required to make a special estimated tax payment equal to the tax benefit attributable to the deduction.

The proposed provision would repeal the Code section 847 elective deduction and related special estimated tax payment rules. The entire balance of an existing account is included in income of the taxpayer for the first tax year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to the inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under section 6655.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would increase revenues by less than \$50 million over 10 years.

KPMG observation

Code section 847 was originally enacted to provide for the admissibility of deferred tax assets associated with loss reserve discounting under the recognition rules of FAS 96.

FAS 109 liberalized these requirements, and, as a result, section 847 is largely unnecessary and administratively burdensome.

The proposal appears identical to one in the House bill.

Capitalize certain policy acquisition expenses (DAC)

The proposed provision would substantially increase the capitalization rates applicable to specified insurance contracts under Code section 848. The current proxy rates applied to net premiums on “specified insurance contracts” are as follows:

- Annuity contracts (1.75%)
- Group life contracts (2.05%)
- All other specified contracts (7.7%)

The current provision allows for a 10-year spread.

The proposed provision is as follows:

- Annuity contracts (3.7%)
- Group life contracts (3.72%)
- All other specified contracts (13.97%)

The proposal would extend the amortization period from a 120-month period to the 600-month period beginning with the first month in the second half of the tax year. The proposal would not change the special rule providing for the 60-month amortization of the first \$5 million (with phase-out).

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would increase revenues by approximately \$23 billion over 10 years.

KPMG observation

When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. The proposal would have the effect of significantly increasing the amount of DAC capitalized as well as extending the amortization period to 50 years and would have a substantial impact on reducing current deductions for these expenses. The proposed 50-year amortization period would result in a DTA that amortizes over an exceptionally long period. In addition, the increased amortization amounts appear to continue to be capped by the company's general expenses. There also may be a significant change in the amount of the admitted DTA relating to DAC for statutory reporting purposes. The House bill does not currently suggest a change to DAC. Ways and Means Committee Chairman Brady's mark initially increased the DAC capitalization rates, but that proposal was withdrawn during the markup and an 8% surtax on life insurance companies was inserted as a placeholder.

Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules

Under current law section 101(a)(1) there is an exclusion from federal income tax for amounts received under a life insurance contract paid by reason of the death of the insured. Under section 101(a)(2), under the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable is generally limited.

Further, in Revenue Ruling 2009-13, the IRS ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of a sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup") and excess is long-term capital gain.

In Revenue Ruling 2009-14, the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (ex. premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

The Finance Committee bill would impose reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the insurance company issuing the life insurance or annuity

contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

The JCT has estimated that these provisions would increase revenues by approximately \$0.2 billion over 10 years.

Reporting requirements for acquisitions of life insurance contracts

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the tax year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract. Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, and (4) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of seller's basis in the life insurance contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), (2) the name, address, and TIN of the seller or the transferor to a foreign person, and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the gross amount of the payment; (2) the taxpayer identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale. For purposes of these reporting requirements, a

payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

Determination of basis

The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as “cost of insurance”). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured’s (seller’s) basis is reduced by the cost of insurance.

Scope of transfer for value rules

The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017. The clarification of the basis rules for life insurance and annuity contracts is effective for transactions entered into after August 25, 2009. The modification of exception to the transfer for value rules is effective for transfers occurring after December 31, 2017.

KPMG observation

The provision would add to the insurer’s reporting responsibilities by requiring it to identify and report seller information to the IRS. In addition, the reversal of the IRS’s position in Rev. Rul. 2009-13 simplifies the insurer’s reporting responsibilities by eliminating the bifurcated basis and investment in the contract calculations for contracts surrendered at a gain vs. contracts surrendered at a loss. Whether or not to reduce a seller’s basis by the cost of insurance has been a controversial issue, and the provision provides clarity to this situation. This provision was not in the House bill.

Tax-exempt organizations

The bill includes a number of proposed changes that would affect tax-exempt organizations.

KPMG observation

The bill does not include certain provisions relevant to tax-exempt organizations that are in the House bill, including:

- Termination of private activity bonds
- Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed
- Clarification of unrelated business income tax treatment of entities treated as exempt from taxation under section 501(a)
- Exclusion of research income limited to publicly available research
- Simplification of excise tax on private foundation investment income
- Private operating foundation requirements relating to operation of art museum
- 501(c)(3) organizations permitted to make statements relating to political campaign in ordinary course of activities
- Additional reporting requirements for donor advised fund sponsoring organizations

Unless otherwise stated, the provisions described below would be effective for tax years beginning after December 31, 2017.

Excise tax on investment income of private colleges and universities

The bill would impose a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 students and non-exempt use assets with a value at the close of the preceding year of at least \$250,000 per full-time student. A university's assets would include assets held for the university by certain related organizations (including supporting organizations to the university and organizations controlled by the university), and a university's net income would include investment income derived from those assets held for the university.

The JCT estimated the provision would increase revenues by approximately \$2.5 billion over 10 years.

KPMG observation

The proposal would not apply to public colleges or universities even if similarly situated in asset size to their private counterparts.

The House bill includes a nearly identical provision, although it does not specify that assets held by a related organization must be "held for" the university in order to generate investment income that would be subject to the excise tax.

Name and logo royalties treated as unrelated business taxable income

The bill proposes treating the sale or license of a tax-exempt organization's name or logo (including any related trademark or copyright) as a per se unrelated trade or business. The proposal would also amend section 512 to provide that any income from such activities is included in unrelated business taxable income ("UBTI"), notwithstanding certain exclusions of passive income (including royalties) from UBTI otherwise available.

JCT estimated the provision would increase revenues by approximately \$2 billion over 10 years.

KPMG observation

Under current law, UBTI generally does not include income from the sale or license of a tax-exempt organization's name or logo (section 512(b)(2), (5)). However, the bill would modify section 513 to explicitly define such license or sale as an unrelated trade or business regularly carried on and would amend section 512 (including section 512(b)(2) and 512(b)(5)) to ensure income from these activities could not be excluded from UBTI.

The House bill does not include a similar provision.

Unrelated business taxable income separately computed for each trade or business

Under the bill, a tax-exempt organization would be required to calculate separately the net UBTI of each unrelated trade or business. Any loss derived from one unrelated trade or business could not be used to offset income from another unrelated trade or business, and net operating loss (NOL) deductions would be allowed only with respect to the trade or business from which the loss arose.

JCT estimated the provision would increase revenues by approximately \$3.2 billion over 10 years.

KPMG observation

Currently, tax-exempt organizations calculate UBTI based on all unrelated business activities regularly carried on, less the deductions directly connected with carrying on those activities. In other words, losses generated by one activity generally can offset income earned from another activity. The bill would prevent organizations from calculating UBTI on an aggregate basis.

The proposal does not address how tax-exempt organizations would treat existing NOLs (i.e., computed on an aggregate basis) under the separate UBTI computation. If the proposal would require organizations to "trace" existing NOLs to the activity that generated them, it could effectively disallow the NOLs because the 20-year carryforward could make it difficult, if not impossible, to identify the corresponding activity.

The House bill does not include a similar provision.

Repeal of tax-exempt status for professional sports leagues

The bill would make professional sports leagues ineligible for section 501(c)(6) tax-exempt status.

JCT estimated the provision would increase revenues by approximately \$100 million over 10 years.

KPMG observation

The bill would not affect the ability of amateur sports leagues to obtain exemption under section 501(c)(3). Although the National Football League voluntarily relinquished its tax-exempt status in 2015, there are a number of other professional sports leagues (and associations) that still rely on tax-exempt status, including foreign organizations that rely on section 501(c)(6) to exempt their income from withholding.

The House bill does not include a similar provision.

Modification of taxes on excess benefit transactions (intermediate sanctions)

The bill would make significant modifications to the intermediate sanctions excise tax (section 4958):

- Expand the excise tax to section 501(c)(5) organizations (i.e., labor, agricultural, and horticultural organizations) and section 501(c)(6) organizations (i.e., business leagues, chambers of commerce, real estate boards, and boards of trade)
- Add athletic coaches of educational institutions and investment advisors as statutory disqualified persons
- Define an “investment advisor” as any person compensated by an organization who is primarily responsible for managing the investment of, or providing investment advice with respect to, assets of the organization, while retaining the existing definition for a sponsoring organization of a donor advised fund
- Eliminate the rebuttable presumption of reasonableness (currently, Reg. section 53.4958-6), which sets forth procedures an organization (and organization manager) may choose to follow to demonstrate that an arrangement or transfer involving a disqualified person is reasonable
- Impose an entity-level excise tax of 10% when an intermediate sanctions excise tax is imposed on a disqualified person, unless the participation of the organization in the transaction is not willful and is due to reasonable cause

- Establish minimum standards of due diligence (i.e., advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) that an organization may follow to avoid the entity-level excise tax
- Preclude organization managers from relying on professional advice for purposes of avoiding the manager-level tax

JCT estimated the provision would have negligible revenue effects.

KPMG observation

The bill's changes to the intermediate sanctions rules would significantly change current law by subjecting two new types of tax-exempt organizations to these rules, imposing a new entity-level excise tax, broadening the class of statutory disqualified persons, and removing certain protections presently available to tax-exempt organizations and their managers.

Despite incorporating the rebuttable presumption procedures as statutorily defined due diligence procedures, the proposal creates uncertainty for organizations, disqualified persons, and organization managers as to the reasonableness of compensation and the likelihood of being subject to an excise tax. Under current law, the rebuttable presumption does not preclude the IRS from imposing an excise tax, it merely shifts the burden from the taxpayer (proving it reasonable) to the IRS (proving that it is unreasonable). There would be no similar burden shifting under this provision.

The House bill does not include a similar provision.

Exception from private foundation excess business holding tax for independently-operated philanthropic business holdings

The bill would create an exception to the excise tax applicable to a private foundation's ownership (generally more than 20%) in a for-profit business. To meet the proposed exception, the private foundation must satisfy the following conditions:

- It holds all ownership interests in the for-profit business;
- It acquired all of its interests in the for-profit business under the terms of a will or trust upon the death of the testator or settlor;
- It distributes all of its net operating income in any given tax year (less a reasonable reserve) to the private foundation; and

- No substantial contributor (or family member) of the private foundation is a director officer, employee, or contractor of the for-profit business; at least a majority of the private foundation's board of directors does not consist of directors or executives of the for-profit business or members of a substantial contributor's family; and there is no loan outstanding from the for-profit business to a substantial contributor (or family member).

JCT estimated this provision would increase revenues by less than \$50 million over 10 years.

KPMG observation

This proposal has bipartisan support and has been introduced separately in both the 114th and 115th Congress. It would permit foundations to continue to own a business enterprise that is unrelated to the exempt purposes of the foundation, if the business is independently operated and its profits are dedicated to tax-exempt purposes. The proposal would permit the business to retain a reasonable reserve for working capital and other business needs.

The House bill includes a nearly identical provision, although it requires only that the interests in the for-profit business be acquired "not by purchase," and not specifically under the terms of a will or trust upon the death of the testator or settlor.

Denial of deduction for college athletic event seating rights

The bill would eliminate the charitable contribution deduction for payments made for the benefit of a higher education institution that grant the donor the right to purchase seating at an athletic event in the athletic stadium of such institution. Current law (section 170(l)) generally permits a deduction of 80% of the value of the payment.

JCT estimated the provision would increase revenues by approximately \$1.9 billion over 10 years.

KPMG observation

The House bill includes an identical provision.

Repeal of substantiation exception in case of contributions reported by donee

The bill would repeal an inactive provision that exempts donors from substantiating charitable contributions of \$250 or more through a contemporaneous written acknowledgment, provided that the donee organization files a return with the required information.

JCT estimated the provision would have negligible revenue effects.

KPMG observation

The House bill includes an identical provision.

International

In the context of international tax, the Finance Committee bill follows the approach of the House bill in eliminating any element of deferred taxation on foreign income within a US-parented multinational group—income is taxed as earned or is permanently exempt from U.S. taxation. Also in keeping with the House bill, the Finance Committee bill retains current subpart F to provide full and immediate taxation of the classes of income that are captured by current law, and would subject a new, very broad, class of income (“global intangibles low-taxed income” under the Finance Committee bill, and “foreign high return income” under the House bill) to immediate taxation at a reduced rate. In contrast to the House bill, however, the Finance Committee bill extends the benefit of the reduced rate to a new class of income earned directly by a U.S. corporation (“foreign derived intangibles income”).

When it comes to proposals to combat base erosion, the Finance Committee bill goes beyond the House bill. Interest expense limitations are expanded in a variety of ways, and deductions are disallowed for transactions involving related parties and hybrid instruments or transactions. While the excise tax regime of the House bill is not present, a new proposal would impose an alternative minimum tax focused on deductible payments made by U.S. persons to related foreign persons.

As with the House bill, the sum total of these changes would represent a significant expansion of the base of cross-border income to which current U.S. taxation would apply.

Establishment of participation exemption system for taxation of foreign income

Add U.S. participation exemption

Similar to new section 245A of the House bill, the Finance Committee bill would allow a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a foreign corporation a 100% dividends received deduction (“DRD”) for the foreign-source portion of dividends received from the foreign corporation (a “100% DRD”).

The foreign-source portion of a dividend would be equal to the same proportion of the dividend as the foreign corporation’s foreign earnings bears to its total undistributed earnings. A foreign corporation’s undistributed foreign earnings would consist of all

undistributed earnings except for income effectively connected with the conduct of a trade or business in the United States and dividend income received from an 80%-owned domestic corporation. Total undistributed earnings include all earnings without reduction for any dividends distributed during the tax year.

New section 245A of the House bill would treat a foreign corporation's pre-1987 earnings in the same manner as its post-1986 earnings, but the Finance Committee bill does not expressly address this issue. Similarly, while the House bill makes it clear that nimble dividends (i.e., dividends paid out of current year earnings when there is an overall accumulated deficit at year end) are eligible for the 100% DRD, the Finance Committee bill does not expressly address nimble dividends.

Contrary to the House bill, the Finance Committee bill provides that a DRD is not available for any hybrid dividend, which is generally defined as an amount received from a controlled foreign corporation ("CFC") for which the foreign corporation received a deduction or other tax benefit related to taxes imposed by a foreign country. Additionally, to the extent a domestic corporation is a U.S. shareholder with respect to tiered CFCs, a hybrid dividend paid from a lower-tier CFC to an upper-tier CFC will be treated as subpart F income to the upper-tier CFC, and the U.S. shareholder will be required to include in gross income an amount equal to the shareholder's pro rata share of subpart F income.

A corporate U.S. shareholder may not claim a foreign tax credit ("FTC") or deduction for foreign taxes paid or accrued with respect to any dividend allowed a 100% DRD. Additionally, for purposes of calculating a corporate U.S. shareholder's Code section 904(a) FTC limitation, the shareholder's foreign source income would not include: (i) the entire foreign source portion of the dividend, and (ii) any deductions allocable to a 100% DRD (or stock that gives rise to a 100% DRD).

In addition to owning 10% of the voting power of the foreign corporation, a domestic corporation would need to satisfy a holding period requirement. Specifically, a domestic corporation would not be permitted a 100% DRD with respect to a dividend paid on any share of stock that is held for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the dividend is paid. Additionally, the foreign corporation must qualify as a specified 10% foreign corporation and the domestic corporation must likewise qualify as a 10% shareholder at all times during the period. The House bill only required that the domestic corporation be a U.S. shareholder of the foreign corporation for more than 180 days during the 361-day period beginning 180 days before the dividend is paid.

The Finance Committee bill DRD proposal is effective for tax years beginning after December 31, 2017 and is expected to reduce revenues by approximately \$215.5 billion over 10 years.

KPMG observation

The 100% participation exemption system would move the United States away from a worldwide tax system and closer to a territorial tax system for earnings of foreign corporations, but only to the extent those earnings are neither subpart F income, nor subject to the minimum tax rule discussed below. As noted above, the participation exemption proposal largely follows the participation exemption proposal in the House bill, which was modeled after former House Ways and Means Committee Chairman Dave Camp's 2014 Discussion Draft. For corporations earning only foreign source income, the mechanics of the new participation exemption are largely irrelevant.

Add special rules relating to sales or transfers involving specified 10% owned foreign corporations

The Finance Committee bill would allow certain deemed dividends under Code section 1248 to qualify for a 100% DRD. Specifically, if a domestic corporation has gain from the sale or exchange of stock of a foreign corporation that it has held for at least one year, any amount that is treated as a dividend under Code section 1248 would be eligible for the 100% DRD. The proposal also includes special subpart F inclusion rules that would have the result of allowing a U.S. shareholder a 100% DRD with respect to gain on the sale of foreign stock by a CFC that is treated under section 964(e) as a dividend to the selling CFC. However, E&P of a selling CFC will not be reduced by any loss from the sale or exchange. The House bill did not address the interaction of Code sections 1248 and 964(e) with the House bill's participation exemption system.

Consistent with the House bill, the Finance Committee bill provides two loss limitation rules.

First, the Finance Committee bill provides that if U.S. shareholder that is domestic corporation receives a dividend from a foreign corporation that is allowed a 100% DRD, solely for the purposes of determining the domestic corporation's loss on the sale of stock of the foreign corporation, the domestic corporation would reduce its basis in the stock of the foreign corporation by an amount equal to the 100% DRD.

Second, the Finance Committee bill would require domestic corporations to recapture foreign branch losses in certain foreign branch transfer transactions. If a domestic corporation transfers substantially all the assets of a foreign branch (within the meaning of Code section 367(a)(3)(C)) to a 10% owned foreign corporation of which it is a United States shareholder after the transfer, the domestic corporation would have to include in gross income the "transferred loss amount" ("TLA") with respect to such transfer.

The TLA is defined as the excess (if any) of:

- The sum of losses incurred by the foreign branch and allowed as a deduction to the domestic corporation after December 31, 2017, and before the transfer, over
- The sum of (1) any taxable income of such branch for a tax year after the tax year in which the loss was incurred, through the tax year of the transfer, and (2) any amount recognized under the section 904(f)(3) “overall foreign loss recapture” (OFLR) provisions on account of the transfer.

As with the House bill, the amount of the domestic corporation’s income inclusion under this proposal would be subject to limitations. Furthermore, the Finance Committee bill changes the source of “branch loss recapture” (BLR) income from foreign source to U.S. source.

The proposal requiring basis adjustments to a foreign corporation’s stock would be effective for dividends received in tax years beginning after December 31, 2017.

The proposal relating to the TLA inclusions would be effective for transfers made after December 31, 2017.

The combined proposals are expected to increase revenues by approximately \$11.3 billion over 10 years.

KPMG observation

The Finance Committee bill proposal is essentially the same as proposed section 4003 of the House bill. The 2014 reform proposal contained a similar loss limitation provision that also required taxpayers also to carry forward and include in future income the portion of the TLA that was subject to a limitation and thus not included in gross income in the year of transfer. While section 91 as proposed by the House bill does not include this carry forward rule, the Finance Committee bill contains a substantial limitation on the gross income inclusion that is tied to the section 245A DRD amount.

Both the House bill and the Finance Committee bill dovetail TLA inclusions with the OFLR provisions and BLR provisions to avoid double inclusions and to provide ordering rules when there are overlapping applications of section 91 and one or both of these provisions. As a general matter, it appears that both proposals are intended to ensure that branch loss recapture is not limited to built-in gain, which is a limitation on both the OFLR and BLR provisions. The House bill and the Finance Committee bill would apply both to recognition and non-recognition transactions and would not be limited to foreign branch built-in gain. Neither of the new proposals, however, provide a coordination rule with the dual consolidated loss recapture provisions, creating uncertainty in situations in which section 91 and the dual consolidated loss recapture overlap. While both proposals and

dual consolidated loss recapture are not the same, the dual consolidated loss recapture provisions apply both to recognition and non-recognition transactions and in many situations require recapture of amounts in excess of foreign branch built-in gain. Thus, the provisions in many situations already achieve the apparent desired result of the new House bill and the Finance Committee bill proposals.

Mandatory repatriation

The Finance Committee bill includes a transition rule to effect the participation exemption regime added by the bill. This transition rule would provide that the subpart F income of a specified foreign corporation (SFC) for its last tax year beginning before January 1, 2018, is increased by no less than its accumulated deferred foreign income (deferred income) as of November 9, 2017 (a measuring date). The Finance Committee bill leaves open the possibility that other dates may be treated as the measuring date or, potentially, as additional measuring dates. A taxpayer generally includes in its gross income its pro rata share of the deferred income of each SFC with respect to which the taxpayer is a U.S. shareholder. This inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer's share of the foreign E&P deficit of each SFC with respect to which it is a U.S. shareholder.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's income inclusion at a 10% rate to the extent it is attributable to the shareholder's cash position and at a 5% rate otherwise.

KPMG observation

Unlike the House bill, the Finance Committee bill's transition rule uses a single measuring date. With this said, the Finance Committee bill provides that another measuring date may be used "as appropriate," so it's unclear whether the forthcoming Senate bill will include provisions that allow for a different or additional measuring date. The Finance Committee bill's November 9 measuring date adds complexity to its transition rule because it would require each SFC to calculate its deferred income or E&P deficit on a date that is not likely to coincide with regular reporting cycles. The House bill included two measuring dates (November 2, 2017, and December 31, 2017) and thus, unlike the Finance Committee bill, requires SFCs to compute their deferred income or E&P deficits twice.

Under the Finance Committee bill and similar to the House bill, taxpayers that have been in the process of planning to reduce E&P in anticipation of a mandatory repatriation by filing accounting method changes may still be able to file a Form 3115 to be effective for 2017 and the E&P would include the full section 481(a) adjustment determined as of the beginning of 2017, as well as transactions affecting the new method through November 9, 2017.

SFC and U.S. shareholder definitions

An SFC is a foreign corporation that has at least one “U.S. shareholder.” The Finance Committee bill’s changes to the Code’s subpart F provisions include two amendments that significantly broaden the current definition of “U.S. shareholder.” First, a U.S. shareholder (the definition of which is modified in another provision of the Finance Committee bill) is now any U.S. person that owns at least 10% of the vote or value of a foreign corporation. Second, section 958(b)(4) is removed by another provision of the Finance Committee bill. Thus, “downward attribution” of stock ownership from foreign persons is taken into account for purposes of determining whether a U.S. person is a U.S. shareholder of a foreign corporation. Both of these amendments would apply for purposes of the Finance Committee bill’s transition rule because they are effective for the last tax year of foreign corporations beginning before January 1, 2018 and all subsequent tax years and for the tax years of a U.S. shareholder with or within which such tax years end.

KPMG observation

The Finance Committee bill’s definition of “U.S. shareholder” includes domestic corporations, partnerships, trusts, estates, and U.S. individuals that directly, indirectly, or constructively own 10% or more of a SFC’s voting power or value. As a result, non-corporate U.S. shareholders are exposed to inclusions under the Finance Committee bill’s transition rule even though the going forward exemption regime for dividends from foreign subsidiaries in the Finance Committee bill will only apply to corporate U.S. shareholders.

The Finance Committee bill’s definition of SFC and changes to the current definition of U.S. shareholder and section 958(b)(4) appear to make the Finance Committee bill’s transition rule much broader than the House bill’s transition rule in several important ways. The House bill would limit SFCs to include only: (i) controlled foreign corporations (CFCs), and (ii) foreign corporations with at least one corporate U.S. shareholder. The Finance Committee bill does not appear to be so limited and, as a result, appears to apply to non-CFC foreign corporations with only non-corporate U.S. shareholders. Also, the House bill would only eliminate section 958(b)(4) for purposes of determining whether a foreign corporation is a SFC by reason of having a corporate U.S. shareholder (within the meaning of current section 951(b)) and for purposes of determining whether a U.S. person is a U.S. shareholder of a CFC after the House bill is effective. The Finance Committee bill eliminates section 958(b)(4) for all purposes for the last tax year of foreign corporation’s beginning before January 1, 2018 and all subsequent years. Thus, downward attribution from foreign persons to U.S. persons appears to apply for purposes of determining which U.S. persons are U.S. shareholders subject to the Finance Committee bill’s transition. Additionally, the mark stated that its transition rule “applies to all U.S. shareholders” and provides the following footnote for U.S. shareholders: “Sec. 951(b), which defines United States shareholder as any U.S. person that owns 10% or more of the voting classes of stock of a foreign corporation.” Although the bill would amend section 951(b) to add a 10%-or-greater value component to the definition of “U.S.

shareholder,” this footnote only refers to the voting component of section 951(b). Thus, this footnote makes it difficult to determine the exact scope of the transition rule.

For example if the’s transition rule applies to U.S. shareholders determined without regard to section 958(b)(4), if a domestic corporation owns 9% of a foreign affiliate, the remaining 91% of which is owned by the domestic corporation’s foreign parent, the foreign affiliate is a SFC and the domestic corporation is a U.S. shareholder of the affiliate. Therefore, the domestic corporation would have to include its pro rata share of the foreign affiliate’s deferred income, although the amount of the domestic corporation’s inclusion would be based solely on its direct and indirect ownership (here, 9%) of the foreign affiliate and only take into account E&P accrued during periods the foreign affiliate was a SFC.

Deferred income and E&P deficits

Deferred income is a SFC’s E&P accumulated in tax years beginning after December 31, 1986, determined as of the measuring date (i.e., November 9, 2017 or as otherwise provided) and that are not attributable to effectively connected income or amounts included in income under subpart F (either previously or in the tax year to which the transition rule applies) (post-1986 E&P). For these purposes, a SFC’s post-1986 E&P are not reduced for distributions during the tax year that includes the measuring date and only takes into account E&P accumulated in periods when the foreign corporation was a SFC. A U.S. shareholder can reduce, but not below zero, its pro rata share of a SFC’s deferred income by its allocable share of its SFCs’ post-1986 E&P deficits. The Chairman’s modifications clarified that a U.S. shareholder’s mandatory inclusion is generally reduced by foreign E&P deficits, including qualified deficits.

Chairman Hatch released a manager’s amendment on November 16 that would exclude deferred foreign income from a REIT’s gross income for purposes of the 95% and 75% gross income tests of section 856(c). Additional details with respect to this addition can be found in the REIT discussion later in this report.

KPMG observation

The Finance Committee bill, similar to the House bill and the 2014 reform proposal, computes post-1986 E&P without regard to current year distributions. This “add-back” may reduce the expected U.S. federal income tax benefits of commonly used E&P and FTC-planning techniques that were recently completed in anticipation of tax reform.

It is possible that the Finance Committee bill’s measuring date falls in the tax year that immediately precedes the year in which the SFC’s deferred income is included in its subpart F income (e.g., a SFC with a November 30 tax year end). In this case, it appears that a SFC’s current year distributions would not be attributed to current year previously taxed income (PTI) under section 959, because PTI only takes into account amounts that have been or are taxed—not amounts that will be taxed. If a SFC’s distributions are added

back to its post-1986 E&P for purposes of determining its deferred income but are not treated as PTI, it appears that distributed E&P is double counted: once with respect to the SFC and once with respect to the recipient (either an upper-tier SFC or a U.S. shareholder).

The Finance Committee bill's definition of post-1986 E&P only includes E&P of a foreign corporation accumulated during periods when the foreign corporation was a SFC. This is more favorable than the House bill's transition rule, which would treat as deferred income all of a SFC's post-1986 E&P whether or not the E&P was accumulated during period when the corporation was a SFC.

Although the Finance Committee bill's definition of post-1986 E&P appears more favorable than the definition included in the House bill, the Finance Committee bill, like the House bill, does not define post-1986 E&P by reference to the period that a U.S. shareholder has directly or indirectly owned a SFC. Thus, it appears that a U.S. shareholder must include its pro rata share of a SFC's post-1986 E&P that accumulated during periods the foreign corporation was a SFC as a result of another U.S. shareholder's ownership.

The Finance Committee bill's E&P deficit provisions are similar to the House bill and the 2014 reform proposal because they allow a U.S. shareholder to benefit from its share of its SFC post-1986 E&P deficits. However, unlike the House bill, the Finance Committee bill does not include rules that allow a U.S. shareholder to reduce its aggregate deferred income for net E&P deficits of its affiliates. Also, unlike the JCT description of the House bill, the Finance Committee bill does not state that hovering E&P deficits are taken into account for this purpose. Thus, the Finance Committee bill's E&P deficit rules appear stricter than the House bill's E&P deficit rules.

Participation exemption

Under the Finance Committee bill's participation exemption, a U.S. shareholder is taxed at reduced rates on its mandatory inclusion. The portion of the inclusion attributable to the U.S. shareholder's cash position is taxed at 10% and the remaining portion is taxed at 5%. The participation exemption uses a deduction to achieve these reduced rates. The amount of a U.S. shareholder's deduction is the sum of the amounts necessary to tax its mandatory inclusion attributable to its cash position at 10% and all other deferred income at 5%.

A U.S. shareholder's cash position is the greater of the pro rata share of the cash position of all SFCs as of the last day of the tax year of the mandatory inclusion or the average of the cash position determined on the last day of each of the two tax years ending immediately before the measuring date (i.e., November 9, 2017, or as otherwise provided). The mark notes that rules will be provided to prevent double counting of cash assets.

KPMG observation

The Finance Committee bill's deduction is modeled after the House bill and the 2014 reform proposal. The Finance Committee bill's deduction is less taxpayer-friendly than the 2014 reform proposal because the latter provided a similar deduction that resulted in deferred E&P attributable to liquid assets being taxed at an 8.75% tax rate and all other deferred E&P being taxed at a 3.5% rate. However, the Finance Committee bill's deduction is more taxpayer-friendly than the House bill's deduction, because the House bill's deduction results in deferred income being taxed at a 14% rate to the extent attributable to a U.S. shareholder's cash position and a 7% rate otherwise.

The House bill tied the calculation of its deduction to the corporate income tax rate, even though its deduction applies to corporate and non-corporate U.S. shareholders. The currently available documents with respect to the Finance Committee bill do not specifically provide which tax rate would apply for purposes of its deduction. It is possible that the text of the forthcoming Senate bill will take into account the highest tax rate applicable to the particular status of the U.S. shareholder (corporate or individual).

The Finance Committee bill uses different measuring dates than the House bill for measuring a U.S. shareholder's cash position. The Finance Committee bill, unlike the House bill, does not provide what assets are included in a U.S. shareholder's cash position or state that "blocked" assets are excluded from a U.S. shareholder's cash position. The Finance Committee bill does note that rules are provided to avoid double counting of cash assets, but does not provide any specific "anti-double counting" rules.

Foreign tax credits

The Finance Committee bill provides that "[t]he portion of foreign income tax that is deemed paid or accrued with respect to the *taxable portion* of the mandatory inclusion is not creditable or deductible against Federal income tax attributable to the inclusion." (Emphasis added). If this statement is correct, then it appears that a U.S. shareholder would not be allowed to reduce the tax assessed on its mandatory inclusion with foreign tax credits. The bill goes on to provide that foreign tax credits are disallowed for all purposes to the extent that they are attributable to the portion of the mandatory inclusion excluded from taxable income pursuant to the participation deduction (71.4% of the foreign taxes paid attributable to the cash portion of the inclusion taxed at 10% and 85.7% of the foreign taxes paid attributable to the non-cash portion of the inclusion taxed at 5%).

Like the House bill, the Finance Committee bill does allow full use of foreign tax credit carryforwards to offset the mandatory inclusion. The Finance Committee bill does not address the carryforward of any foreign tax credits not used in the tax year of the U.S. shareholder in which the mandatory inclusion is taken into account. However, as noted

below, the Chairman's modification provides rules that coordinate the interaction of existing foreign tax credit carryforward rules and the mandatory inclusion.

KPMG observation

The Finance Committee bill, like the JCT report on the Ways and Means bill, provides that foreign income taxes associated with the taxable portion of a U.S. shareholder's mandatory inclusion are not available to offset the U.S. tax on such amount. This is counter to the language of the House bill, which appears to allow these foreign income taxes as credits. It is unclear whether the discussion in the JCT report on the Ways and Means bill and the Finance Committee bill are drafting errors that will be corrected in the future or, in the case of the JCT report on the Ways and Means bill, whether such discussion represents what the Ways and Means Committee meant to provide in its bill.

The Finance Committee bill "haircuts" the foreign tax credits associated with a U.S. shareholder's mandatory income inclusion by 71.4% for foreign income taxes associated with the portion of the inclusion attributable to the shareholder's cash position and 85.7% for foreign income taxes associated with the other portion of the inclusion. These percentages are equal to the amount of the U.S. shareholder's income inclusion that is offset by the participation deduction that is calculated using a corporate tax rate of 35%. These percentages imply that the Finance Committee bill intends that the participation deduction will be calculated using the highest corporate rate similar to the House bill.

Overall foreign loss recapture

The Finance Committee bill does not provide any discussion of the impact of the mandatory inclusion on a U.S. shareholder's overall foreign loss (OFL), unlike the House bill, or on separate limitation losses (SLLs), unlike the JCT report on the Ways and Means bill. The House bill provides that a U.S. shareholder's OFL recapture amount is unaffected by its income inclusion under section 965 and the JCT report on the Ways and Means bill states that SLLs would likewise be unaffected.

Net operating loss election and coordination rules

The modified mark allows taxpayers to elect out of using net operating losses (NOLs) to offset the mandatory inclusion from the mark's transition rules, thereby allowing taxpayers to preserve their NOLs for future use. The modified mark also provides for rules that would coordinate the interaction of the mark's mandatory inclusion with existing NOLs, overall domestic losses, and foreign tax credit carry-forward rules. However, the modified mark does not provide any detail regarding how these coordination rules will operate.

Payment

The Finance Committee bill is similar to the House bill in that the tax assessed on a U.S. shareholder's mandatory inclusion is payable in the same manner as its other U.S. federal income taxes and that such tax assessed may be paid over an 8-year period. The Finance Committee bill differs from the House bill (which provides for 8 equal payments) and requires that 8% of the tax be paid in each of the first five years, 15% in the 6th year, 20% in the 7th year, and 25% in the 8th year. For both the House bill and the Finance Committee bill, only the U.S. federal income tax due on the mandatory inclusion is eligible to be paid in installments. The Finance Committee bill would accelerate the payment of the tax upon the occurrence of certain "triggering events," which include an addition to tax for failure to timely pay any installment due, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 case), or a cessation of business by the taxpayer to the date of such triggering event. The Finance Committee bill does not provide for any exceptions to acceleration, unlike the House bill.

The manager's amendment to the Finance Committee bill would allow REITs to distribute their deferred foreign income to their shareholders over an 8-year period using the same installment percentages that apply to electing U.S. shareholders. Additional details with respect to this addition can be found in the REIT discussion later in this report.

S corporations

The Finance Committee bill provides that if an S corporation is a U.S. shareholder of a SFC, each shareholder of the S corporation may elect to defer paying its net tax liability on its mandatory inclusion until its tax year that includes a "triggering event" with respect to the liability. A net tax liability that is deferred under this election appears to be assessed as an addition to tax in the electing shareholder's tax year as the bill provides that the electing shareholder (and the S corporation) would be liable, jointly and severally, for the net tax liability and related interest of penalties.

The triggering events listed in the Finance Committee bill are generally the same as the House bill. A "triggering event" for purposes of the bill's S corporation provisions includes the general triggering events noted above, a corporation ceasing to be an S corporation, and the taxpayer's transfer of S corporation stock. If a taxpayer transfers some, but not all, of its S corporation stock, the transfer is only a triggering event with respect to the net tax liability properly allocable to the transferred stock.

An S corporation shareholder that elects to defer paying its net tax liability under the Finance Committee bill's transition rule may also elect to pay this liability in equal installments over an 8-year period after a triggering event has occurred. However, this election is not available if the triggering event is a liquidation, sale of substantially all of the S corporation's assets, termination of the S corporation or cessation of its business, or a similar event. The first installment must be paid by the due date (without extensions)

of the shareholder's U.S. federal income tax return for the year that includes the triggering event.

KPMG observation

The Finance Committee bill, like the House bill, provides a favorable deferral regime for S corporation shareholders because the shareholders can elect to defer paying their net tax liability until there is a triggering event. Moreover, when a triggering event occurs with respect to an electing S shareholder, the shareholder can elect to pay its net tax liability on an installment basis. Although not completely clear, the bill suggests that a shareholder may also elect to pay any tax due in installments even if the shareholder does not initially make the deferral election. The bill does not, however, provide whether S corporation shareholder's installment payments are equal or graduated as generally described above.

Recapture from expatriated entities

The Finance Committee bill includes recapture rules that are intended to deter inversions. Under these rules, if a U.S. shareholder becomes an "expatriated entity" within the meaning of section 7874(a)(2) at any point during the 10-year period following the enactment of the bill, (i) the shareholder would be denied a participation deduction with respect to its mandatory inclusion, (ii) the shareholder's mandatory inclusion would be subject to a 35% tax rate, and (iii) the shareholder would not be able to offset the additional U.S. federal income tax imposed by the recapture rules with foreign tax credits. An entity that becomes a domestic corporation under section 7874(b) is not subject to these recapture rules. The additional tax from these recapture rules arises in, and is assessed for, the tax year in which the U.S. shareholder becomes an expatriated entity.

KPMG observation

For purposes of the Finance Committee bill's recapture rules, an "expatriated entity" is a domestic corporation or domestic partnership the assets of which are acquired by a "surrogate foreign corporation," which is not treated as domestic corporation under section 7874(b), in a "domestic entity acquisition" and any U.S. person related to such domestic corporation or domestic partnership under sections 267(b) or 707(b)(1). A domestic entity acquisition occurs when a foreign corporation directly or indirectly acquires substantially all of the properties directly or indirectly held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership. A foreign corporation is a surrogate foreign corporation that is not a domestic corporation under section 7874(b) if it completes a domestic entity acquisition and in the acquisition, the former shareholders of the domestic corporation or former partners of the domestic partnership, as applicable, receive at least 60% but less than 80% of the vote or value of the foreign corporation's stock "by reason of" (e.g., in exchange for or with respect to) their domestic corporation stock or domestic partnership

interests, as applicable, and after the acquisition doesn't have substantial business activities in its country of creation or organization. The U.S. anti-inversion rules are extremely complex and include many ambiguous provisions.

The House bill's transition rule does not include rules similar to the Finance Committee bill's inversion recapture rules. By incorporating the U.S. anti-inversion rules, the Finance Committee bill's transition rule is more complicated than the House bill's transition rule and could have unintended consequences. In particular, because the definition of expatriated entity includes U.S. persons that share a section 267(b) or 707(b)(1) relationship with the target entity in a domestic entity acquisition, the Finance Committee bill's inversion recapture rules may apply to U.S. shareholders other than the target entity. Also, given the punitive treatment of the amounts subject to the Finance Committee bill's inversion recapture rules, the rules likely would be an important diligence item for future merger and acquisition transactions.

Rules related to passive and mobile income

Current year inclusion of global intangible low-taxed income by United States shareholders

The Finance Committee bill generally describes the addition of new Code section 951A, which would require a U.S. shareholder of a CFC to include in income its "global intangible low-taxed income" ("GILTI") in a manner similar to subpart F income. The bill would allow a deduction equal to 50% of GILTI, which would be reduced to 37.5% starting in 2026, subject to certain revenue targets being attained. In general, GILTI would be the excess of a shareholder's CFCs' net income over a routine or ordinary return.

In general, when a U.S. person is (i) a 10% U.S. shareholder of a CFC (taking into account the broad constructive ownership rules applicable in subpart F) on any day during the CFC's tax year during which the foreign corporation is a CFC; and (ii) the U.S. person owns a direct or indirect interest in the CFC on the last day of the tax year of the foreign corporation on which it is a CFC (without regard to whether the U.S. person is a 10% shareholder on that day), then the U.S. person would be required to include in its own income the GILTI amount allocated to the CFC for the CFC's tax year that ends with or within its own tax year. A U.S. shareholder would increase its basis in the CFC stock for the GILTI inclusion, which generally would be treated as "previously taxed income" for subpart F purposes.

KPMG observation

One of the most important proposals in the Finance Committee bill would impose a tax on a U.S. shareholder's pro rata share of its CFCs' GILTI. Similar to other amounts calculated under subpart F, the GILTI would be included in a U.S. shareholder's income

each year without regard to whether that amount was distributed by the CFC to the U.S. shareholder during the year.

Although lowering the U.S. statutory rate from 35% to 20% presumably would reduce the incentives to erode the U.S. tax base by shifting profits outside the United States, this provision reflects a concern that shifting to a territorial tax system could exacerbate base erosion incentives because any shifted profits would be potentially permanently exempt from U.S. tax. The inclusion of GILTI in a U.S. shareholder's income is intended to reduce those incentives further by ensuring that CFC earnings that are considered to be "non-routine" are subject to some measure of U.S. tax (at a rate potentially as low as 10% for 2019-2025³ when the 50% deduction described above is allowed).

Both the reduction in the corporate tax rate and the exemption from income of dividends received from CFCs are described as increasing the competitiveness of U.S. corporations and levelling the playing field with foreign multinationals. It is worth noting that an immediate tax even at an effective rate of 10% for corporate shareholders (after taking into account the 50% deduction described above) would be comparatively unfavorable to the CFC regimes of most of the major trading partners of the United States, which typically tax CFC earnings in much more limited circumstances.

GILTI. In general, GILTI is described as the excess of a U.S. shareholder's net CFC tested income over its "net deemed tangible income return," which is defined as 10% of its CFCs' "qualified business asset investment".

GILTI seems similar to the "Foreign High Return Amount" ("FHRA") in Section 4301 of the House bill, although the lack of detail in the Finance Committee bill makes a full comparison difficult. Nonetheless, it appears that the two proposals share certain general similarities in methodology and terminology, but also differ in significant ways, including in defining the "tested income" on which the GILTI or FHRA is based.

One significant difference between the GILTI and FHRA rules is that it appears that the full amount of GILTI would be included in a U.S. shareholder's income, while only 50% of the FHRA would be included in income under the House bill. Nonetheless, the Finance Committee bill provides a deduction equal to 50% of GILTI for 2018 through 2025, which would be decreased to 37.5% beginning in 2026, subject to certain revenue targets being attained. As a result, assuming that the new 20% corporate tax rate is in effect, the effective tax rate on GILTI when a shareholder is allowed the 50% deduction would be

³ The effective tax rate on GILTI would be commensurately higher (i) in 2018 prior to the reduction of the corporate tax rate to 20% in 2019; and (ii) starting in 2026 after the GILTI deduction is reduced to 37.5%.

10%⁴. The effective tax rate on FHRA would be 10% for all years. The shift from an exclusion to a dividends received deduction also results in the absorption of net operating losses against the full amount of GILTI rather than merely against the taxable portion.

Tested Income. Finance Committee bill defines net “tested income” as the excess of the aggregate CFCs’ tested income over its tested loss. For this purpose, “tested income” of a CFC generally is described as the gross income of the CFC other than: (i) ECI; (ii) subpart F income; (iii) amounts excluded from subpart F income under the Code section 954(b)(4) high-tax exception; (iv) dividends received from a related person (as defined in Code section 954(d)); and (v) foreign oil and gas extraction income and foreign oil related income, over deductions allocable to such gross income. Tested loss is defined to mean the excess of deductions allocable to such gross income over the gross income.

KPMG observation

Although GILTI and FHRA are each calculated based on a CFC’s “tested income”, the two proposals define “tested income” differently. Both proposals would reduce a CFC’s gross income for ECI, subpart F income, amounts excluded from subpart F under the high-tax exception rule, and dividends from a related person. The FHRA proposal also would reduce gross income for related party amounts excluded from subpart F income under Code section 954(c)(6), active finance income described in Code section 954(h), insurance income described in Code section 954(i) or Code section 953, and dealer income described in Code section 954(c)(2)(C). The GILTI rules do not contain any similar exclusions for purposes of determining net income. Furthermore, the two proposals differ on the exclusion of commodity income. Although the GILTI rules don’t have a commodities exception, they do exclude both foreign oil and gas extraction income as well as foreign oil related income. On the other hand, the FHRA rules exclude commodity income, which generally is defined based on income derived from the disposition of commodities that are produced or extracted by the CFC. The extent to which these two different exclusions overlap may not be clear until more details on the Finance Committee bill are made available.

Net deemed tangible income return. Finance Committee bill describes the “net deemed tangible income return” as 10% of the CFCs’ qualified business asset investment (“QBAI”). QBAI would be determined as the average of the adjusted bases (determined at the end of each quarter of a tax year) in “specified tangible property” that is used in the CFC’s trade or business and is subject to Code section 167 depreciation. The adjusted basis of property would be determined under the alternative depreciation rules of Code section 168(g).

⁴ This effective rate would increase to 12.5% when the deduction is reduced in 2026.

KPMG observation

The GILTI proposal would apply a 10% rate to calculate the net deemed tangible income return or “routine return” on QBAI, while the FHRA proposal would apply a rate of 7% plus the applicable Federal short-term rate on QBAI to determine the routine return. Based on the current rate, the GILTI rate of 10% is higher than the rate that would apply under the FHRA proposal. Both proposals seem to define QBAI in a similar manner, which generally limits relevant assets to depreciable property used in the CFC’s trade or business. Both proposals measure the amount of assets based on their adjusted bases, and the GILTI proposal specifically provides that Code section 168(g) rules would apply in determining basis. The FHRA proposal reduces the routine return by the amount of certain allocable interest expense. No similar reduction to the routine return in the GILTI rules is described in the Finance Committee bill.

In certain cases, the routine return may be negligible, for example because (i) the CFC’s primary value-driver is intangible assets (notably, no relief is given for a return on intangible assets even when a taxpayer has purchase basis in the assets); or (ii) the tangible property is substantially depreciated. As such, the tax base on which the tax is imposed in many cases may be a U.S. shareholder’s ratable share of net tested income without reduction for any sort of routine return.

Deemed-paid foreign tax credit. The Finance Committee bill provides for a limited deemed credit for 80% of the foreign income taxes with respect to GILTI that is includible in a U.S. corporate shareholder’s income. It appears that the deemed-paid credit contained in the mark is calculated similarly to the deemed-paid credit on FHRA in section 4301 of the House bill. The bill describes the methodology to calculate the foreign taxes deemed paid by the domestic corporation as 80% of (i) the domestic corporation’s “inclusion percentage”, multiplied by (ii) the aggregate tested foreign income taxes paid or accrued by all CFCs of which the domestic corporation is a U.S. shareholder with respect to their tested income (as defined above).

The inclusion percentage is described as the ratio of the shareholder’s aggregate GILTI divided by the shareholder’s share of the tested income of the CFCs. This ratio presumably is intended to compare the amount included in the U.S. shareholder’s income and subject to tax in the United States, the GILTI, to the amount with respect to which the relevant foreign taxes are imposed, the tested income, to determine the relevant percentage of foreign taxes that should be viewed as deemed paid for purposes of the credit.

The bill also would modify the Code section 78 gross-up rules to treat the deemed paid taxes as an increase in the GILTI. However, the proposal would compute the section 78 gross-up by reference to 100% of the related taxes, rather than by reference to the 80% that are allowable as a credit.

In addition, the bill would create a separate basket for these deemed paid taxes to prevent them from being credited against U.S. tax imposed on other foreign-source income. Moreover, any deemed-paid taxes on GILTI would not be allowed to be carried back or forward to other tax years.

KPMG observation

Finance Committee bill would impose current tax on a U.S. shareholder's GILTI, but also would allow corporate U.S. shareholders a deemed paid foreign tax credit of 80% of the foreign taxes attributable to the GILTI. In general, as a result of the deemed paid foreign tax credit, a U.S. shareholder generally would be indifferent to the new tax imposed on GILTI when the effective tax rate on the underlying income is at least 15.625% (ignoring base and timing differences), once the new 20% corporate tax rate is in effect.

The FHRA proposal contains a similar deemed FTC rule, pursuant to which taxpayers may not obtain the full benefit of taxes paid by their CFCs when there is at least one loss CFC because the "foreign high return percentage" in the proposal reduces the creditable amount whenever there is at least one loss CFC. Although not free from doubt, it seems that a similar result would occur under the "inclusion percentage" methodology in the deemed FTC rule described in the bill, the numerator of which is described as the aggregate of the CFCs "tested income." It is not clear whether this result is intended in either proposal.

In addition, because there is no carryforward or other provision to mitigate the consequences of timing differences between U.S. and foreign income tax laws, it is possible that U.S. shareholders whose CFCs generally are subject to significant foreign taxes may nonetheless owe residual U.S. tax in a particular year if significant income is recognized in that year for U.S. tax purposes but not for foreign tax purposes. For large multinationals this issue may be mitigated by the ability to average across CFCs, but cyclical businesses nevertheless could be especially susceptible to this problem. Moreover, by precluding carryover, the new deemed FTC proposal may put some taxpayers in a position where they are better off deducting rather than crediting the relevant foreign taxes they are deemed to pay under the proposal.

Finally, as described earlier, the definition of tested income excludes foreign oil and gas extraction income and foreign oil related income. Since extraction income often is subject to a high-rate of effective tax, the exclusion may be an attempt to eliminate opportunities to credit those high effective rate taxes against other low-tax tested income.

These rules would be effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, these rules would increase revenues by \$135.0 billion over 10 years.

KPMG observation

To mitigate the impact of these rules in 2018, U.S. shareholders with a calendar year should consider electing a November 30 year end for their CFCs, in which case the income of their CFCs would not be subject to the tax until December 1, 2018. In the case of a U.S. shareholder with a fiscal year, that U.S. shareholder generally would be exempt from the tax until the first day of the CFC's fiscal year beginning in 2018 (for example, a CFC with a September 30 year-end would become subject to the tax beginning October 1, 2018).

Add deduction for foreign-derived intangible income

In conjunction with the new minimum tax regime on excess returns earned by a CFC, the Finance Committee bill would provide a 12.5% effective tax rate on excess returns earned directly by a U.S. corporation from foreign sales or services, which would increase to 15.625% starting in 2026. Specifically, for tax years 2018-2025, the bill would allow U.S. corporations a deduction equal to 37.5% of the lesser of (1) its "foreign-derived intangible income" ("FDII"), or (2) its taxable income, determined without regard to this new deduction. Starting in 2026, the deduction percentage would be reduced to 21.875%, unless certain revenue targets are attained.

The bill contains a complex set of definitional rules for determining the amount of a U.S. corporation's FDII. At a high level, a U.S. corporation's FDII is the amount of its "deemed intangible income" that is attributable to income received from a foreign person for sales of property or the performance of services for ultimate use outside the United States. A U.S. corporation's deemed intangible income generally is its gross income that is not attributable to a CFC or to a foreign branch over an amount equal to 10% of the aggregate adjusted basis of its U.S. depreciable assets.

The net result of the calculation is that a domestic corporation would be subject to the standard 20% tax rate on its fixed 10% return on its U.S. depreciable assets and a 12.5% (increased to 15.625% as of 2026) tax rate on any excess return that is attributable to exports of goods or services.

In addition, new reporting rules would apply with respect to FDII, which would include a requirement to certify under penalties of perjury that the FDII does not relate to the sales of products into the United States. A monetary penalty of \$1,000 per day (capped at \$250,000) would be imposed for a failure to comply with the new FDII reporting obligations.

The provision would be effective for tax years beginning after December 31, 2017.

KPMG observation

This is a new proposal that was not included in the House bill. The preferential rate on deemed intangible income attributable to export activities, coupled with the provision below regarding transfers of intangible property from CFCs to their U.S. shareholders, presumably is intended to encourage U.S. corporations to keep (or relocate) production activities in the United States. Although it may be beneficial for U.S. corporations to continue to conduct certain activities through a CFC that is subject to a 12.5% (or 15.625%) tax rate on all of its income, the provision notably would tax U.S. corporations at the full 20% corporate rate on income attributable to a foreign branch. It is not entirely clear why the proposal creates such incongruous treatment for activities conducted through a foreign branch versus a CFC.

Add special rules for transfers of intangible property from controlled foreign corporations to U.S. shareholders

The Finance Committee bill would allow a CFC to distribute appreciated intangible property to a corporate U.S. shareholder without triggering a current income inclusion to the shareholder. For this purpose, intangible property is property described in section 936(h)(3)(B) and computer software described in section 197(e)(3)(B). Under current law, a CFC generally would be required to recognize any gain realized on a distribution of intangible property to a U.S. shareholder and that gain generally would be subpart F income, thus subjecting the U.S. shareholder to a current income inclusion. The proposal would change this result by providing that a CFC would not recognize gain on a distribution of appreciated intangible property.

Special basis rules are provided for distributions that are not taxable as dividends. It appears that these rules may have the result of eliminating built-in gain with respect to the stock of the CFC attributable to the distributed intangible but potentially at the cost of reducing the amortizable basis in the distributed intangible.

The provision would apply to distributions made by a CFC to a corporate U.S. shareholder in tax years of the foreign corporation beginning after December 31, 2017, and for tax years of a U.S. shareholder with or within which such tax year of the foreign corporation ends.

KPMG observation

This provision is intended to encourage U.S. multinationals to repatriate valuable intangible property that currently is held offshore by CFCs. Although a distribution of intangible property to a corporate U.S. shareholder would not give rise to current U.S. taxation for the shareholder, any built-in gain in the intangible property would be preserved and potentially subject to future U.S. taxation.

Other modifications of subpart F provisions

Eliminate inclusion of foreign base company oil related income

The Finance Committee bill describes the repeal of section 954(g) of the Code. As a result of this proposal, there would no longer be full U.S. tax currently imposed on foreign oil-related income of a foreign subsidiary. This proposal appears to be identical to section 4202 of the House bill.

KPMG observation

The repeal of section 954(g) of the Code would exclude foreign oil related income from subpart F income. In addition, this income appears to be excluded from current U.S. taxation under the new “global intangible low-taxed income” (GILTI) rules described in the bill, which exclude “foreign oil and gas extraction income and foreign oil related income” from the income of a CFC that is subject to tax when it exceeds a routine return. Although both the Finance Committee bill and the House bill eliminate foreign base company oil-related income from subpart F income, such income may remain subject to current tax under the minimum tax provision in section 4301 of the House bill, which generally excludes income derived from the production and extraction of oil and gas, but does not include a general exclusion for foreign-oil related income.

This provision of the bill would be effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this proposal would reduce revenues by approximately \$4 billion over 10 years.

Inflation adjustment of de minimis exception for foreign base company income

Finance Committee bill describes the amendment of section 954 of the Code to require an inflation adjustment to the \$1 million *de minimis* threshold, with all increases rounded to the nearest multiple of \$50,000. This provision appears to be identical to section 4203 of the House bill.

The provision would be effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this proposal would reduce revenues by approximately \$400 million over 10 years.

Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment

Finance Committee bill would repeal section 955 of the Code. As a result, there would no longer be current U.S. tax imposed on previously excluded foreign shipping income of a foreign subsidiary if there was a net decrease in qualified shipping investments. This provision appears to be identical to section 4201 of the House bill.

The provision would be effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this proposal would reduce revenues by less than \$50 million over 10 years.

Modification of stock attribution rules for determining status as a controlled foreign corporation

Finance Committee bill would eliminate a constructive ownership rule in section 958(b)(4) of the Code that prevents downward attribution of stock owned by a foreign person to a U.S. person. As a result, for example, stock owned by a foreign corporation would be treated as constructively owned by its wholly-owned domestic subsidiary for purposes of determining the U.S. shareholder status of the subsidiary and the CFC status of the foreign corporation. This provision appears to be identical to section 4205 of the House bill, other than an earlier effective date.

The provision would apply to the last tax year of foreign corporations beginning before January 1, 2018, and all subsequent tax years of a foreign corporation, and for the tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this provision, along with the deduction for dividends received, would reduce revenues by approximately \$215.5 billion over 2018-2027. This proposal alone, though, likely would increase revenues as a result of expanding the scope of taxpayers subject to the subpart F rules.

KPMG observation

A primary impact of this provision would be to cause minority U.S. owners of foreign subsidiaries in an inverted group to be treated as U.S. shareholders of CFCs as a result of attribution from the majority foreign owner. These residual owners would become subject to the subpart F rules, including the new GILTI rules. This provision would apply to the last tax year beginning before January 1, 2018, which is a year earlier than the

similar rule in section 4205 of the House bill, which applies to tax years beginning after December 31, 2017.

Modification of definition of United States shareholder

Finance Committee bill describes the revision of the definition of U.S. shareholder in section 951(b) of the Code to include a U.S. person who owns at least 10% of the value of the shares of the foreign corporation. As a result of this provision, a U.S. person would be treated as a U.S. shareholder of a foreign corporation for subpart F purposes when the person owns at least 10% of either the voting power or the value of the foreign corporation. The House bill does not contain any similar provision.

The provision would be effective for the last tax year of foreign corporations beginning before January 1, 2018, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this proposal would increase revenues by approximately \$1.4 billion over 10 years.

KPMG observation

This provision would increase the scope of U.S. persons who are required to include amounts in income under the subpart F rules, and potentially increase the amount of subpart F income that current U.S. shareholders would be required to include in income, when the value of a shareholder's stock in a foreign corporation exceeds the voting power of the stock. The mark does not describe any coordination rules that may be necessary to prevent double-inclusion of subpart F income when multiple U.S. shareholders hold CFC shares with disproportionate vote and value. This new expanded U.S. shareholder definition is proposed to be effective as of the last tax year beginning before January 1, 2018, with the result that an expanded group of U.S. persons could be subject to certain other rules in the bill, including the "mandatory repatriation" rules described elsewhere.

Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply

Finance Committee bill would eliminate the requirement in section 951(a) of the Code for a foreign corporation to constitute a CFC for an uninterrupted period of at least 30 days in order for a U.S. shareholder to have a current income inclusion. As a result, for example, a U.S. shareholder could have a current subpart F inclusion when a CFC generates subpart F income during a short tax year of less than 30 days. This provision appears to be identical to section 4206 of the House bill.

The provision would be effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this proposal would increase revenues by approximately \$400 million over 10 years.

Look-thru rule for related controlled foreign corporations made permanent

Finance Committee bill would make permanent the exclusion from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties under section 954(c)(6) of the Code. This provision appears to be identical to section 4204 of the House bill. As currently enacted, the temporary exclusion in section 954(c)(6) of the Code expires on December 31, 2019.

The provision would be effective for tax years of foreign corporations beginning after December 31, 2019, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this proposal would reduce revenues by approximately \$11.8 billion over 10 years.

KPMG observation

While the amendment of section 954(c)(6) of the Code would exclude from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties, taxpayers need to carefully analyze existing transaction flows to determine whether these types of related-party payments generate CFC “tested income” subject to the new GILTI rules that impose tax on the excess of a CFC’s income over a normal return on tangible assets. In contrast to the similar minimum tax provision in section 4301 of the House bill, there is no general exclusion from “tested income” for amounts excluded from subpart F income under Code section 954(c)(6). As a result, these amounts generally would be included in a CFC’s “tested income” unless an exception described in the bill applies, such as the exception for dividends received from a related person, within the meaning of section 954(d)(3) of the Code. Although a Code section 954(c)(6) payment may be included in a recipient’s GILTI, the payor CFC can reduce its “tested income” by the payment. This framework (a reduction in GILTI for the payor and an increase in GILTI for the recipient) may be easier to administer than the framework in the House bill, which would require a taxpayer to establish that a Code section 954(c)(6) payment did not reduce a payor’s “tested income” in order for the payment to be excluded from the recipient’s “tested income.”

Corporations eligible for deductions for dividends exempted from subpart F inclusions for increased investments in United States property

Consistent with the House bill, the Finance Committee bill would amend Code section 956 to exclude U.S. corporate shareholders of CFCs from having a current income inclusion with respect to investments in U.S. property made by a CFC. The proposal would apply to corporations that are U.S. shareholders in CFCs either directly or indirectly through a partnership.

The provision would be effective for tax years of CFCs beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such years of the CFCs end.

KPMG observation

Under current law, an investment in U.S. property by a CFC may give rise to a current income inclusion to a U.S. shareholder to the extent the investment was made with untaxed earnings. Congress originally enacted Code section 956 because it believed that a CFC's investment of untaxed earnings in U.S. property represented a constructive dividend to the U.S. shareholders that should be currently taxed to the U.S. shareholders as if the CFC actually distributed a dividend. Because actual distributions of untaxed earnings to U.S. corporate shareholders would not be subject to U.S. taxation under the participation exemption system discussed above, there would be no tax-avoidance reason for U.S. corporate shareholders to be subject to taxation by reason of a CFC's investment in U.S. property.

Prevention of base erosion

Deny deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic interest

Like section 4302 of the House bill, the Finance Committee bill would limit the amount of interest a domestic corporation can deduct to a measure of its proportionate share of the worldwide group's external indebtedness. Like section 4302 of the House bill, the limitation for disproportionate indebtedness in the Finance Committee bill would apply *in addition to* the Finance Committee bill's new *general* disallowance of net interest expense under Code section 163(j), which corresponds to section 3301 of the House bill. As in the House bill, the provision that denies the greater amount of interest deductions applies.

Although section 4302 of the House bill also includes a proposal to disallow a measure of disproportionate interest, there are a number of very significant differences between the two proposals.

One significant difference is the scope of companies covered by each proposal. Unlike the House bill, which would apply to a U.S. corporation that is a member of any “international financial reporting group” (“IFRG”), the Senate provision would apply only to U.S. corporations that are members of an “affiliated group” of corporations. For this purpose, affiliated group is defined by reference to Code section 1504, but substituting a 50% ownership threshold (by vote and value) for the 80% threshold contained in Code section 1504(a)(2), and by disregarding Code section 1504(b)(3) so as to permit inclusion of foreign corporations in the “affiliated group.” By contrast, in the House bill, an IFRG is a group of entities that: (1) includes at least one foreign corporation engaged in a trade or business in the United States or at least one domestic corporation and one foreign corporation; (2) prepares consolidated financial statements for the reporting year; and (3) reports annual gross receipts in excess of \$100 million. Perhaps most significantly, the JCT description of the Finance Committee bill does not contain an annual gross income requirement.

KPMG observation

The Finance Committee bill potentially would apply to a 50-50 joint venture with an unrelated person, because it lowers the ownership threshold in Code section 1504(a)(2) from “at least 80%” to “at least 50%” by vote and value. Presumably the Senate Finance Committee chairman’s and the House Ways and Means’ proposals to limit the ability of U.S. members of a multinational group to claim disproportionate interest deductions are premised on the notion that money is fungible, and that absent such limits, multinational groups can substitute debt for equity in controlled entities depending on whether the entity is in a low- or high-tax jurisdiction. In joint ventures involving unrelated parties, however, the choice of financing through debt versus equity could have significant deal implications when the partners hold disproportionate interests in the debt.

Another important point with respect to scope: The Ways and Means Committee approved a manager’s amendment to the Ways and Means bill on November 9 that, among other things, broadens the exception to the limitation provided in new Code section 163(j) to a “trade or business that has had floor plan financing indebtedness,” in addition to the regulated utilities and real property businesses, which were already excepted from the scope of the provision. The corresponding Senate provision does not reflect that amendment to the Ways and Means bill but otherwise includes the exceptions for regulated utilities and real property companies. Similar exceptions are *not* provided for in either the House or Senate proposals relating to disproportionate interest expense. Thus, as currently drafted, these companies, if part of a worldwide affiliated group (under the Senate Finance Committee Chairman’s version) or an IFRG (under the House version) could be subjected to proposed Code section 163(n).

In sharp contrast to the House bill, which uses an earnings-related measure of excessive interest expense, the Finance Committee provision takes a balance sheet approach. Specifically, the provision would reduce the deduction for interest paid or accrued by an

affected U.S. corporation by the product of the U.S. corporation's net interest expense and the "debt-to-equity differential percentage" of the worldwide affiliated group.

Net interest expense is defined as the excess (if any) of: (1) interest paid or accrued by the U.S. corporation during the tax year, over (2) the amount of interest includible in the gross income of the U.S. corporation for the tax year.

The debt-to-equity differential percentage of the worldwide affiliated group is defined as the "excess domestic indebtedness" of the group divided by the total indebtedness of the domestic corporations that are members of the group. "Excess domestic indebtedness" is the amount by which the total indebtedness of the U.S. members exceeds 110% of the total indebtedness those members would hold if their total indebtedness to total equity ratio were proportionate to the ratio of total indebtedness to total equity in the worldwide group. Total equity means, with respect to one or more corporations, the excess (if any) of: (1) the money and all other assets of such corporations, over (2) the total indebtedness of such corporations. Intragroup debt and equity interests are disregarded for purposes of this computation. All U.S. members of the worldwide affiliated group are treated as one member when determining whether the group has excess domestic indebtedness as a result of a debt-to-equity differential.

KPMG observation

Though not explicitly stated in the JCT description, it appears that the debt-to-equity differential percentage must be computed using balance sheets based on U.S. tax principles. This is a significant departure from the House bill, which would calculate the interest limitation based on amounts reported in the group's financial statements. A requirement to compute a U.S. tax balance sheet could be quite burdensome for a foreign-parented company that has a majority of its operations outside of the United States. Presumably, a motivating factor for the House bill's reliance on the financial statements was to alleviate this burden.

Disallowed interest expense under the Finance Committee bill can be carried forward indefinitely. In contrast, section 4302 of the House bill would only permit disallowed net interest expense to be carried forward for five years.

The Senate proposal provides the Secretary with regulatory authority to provide rules to: (1) prevent the avoidance of the proposal, (2) coordinate the proposal with section 884, (3) address the treatment of partnership indebtedness and the allocation of partnership debt, interest, and distributive shares, and (4) coordinate the proposal with section 163(j).

KPMG observation

While the House bill specifically includes partnerships and foreign corporations within the purview of its proposal, the application of the Senate proposal to these entities is left to

regulatory authority. Therefore, if the Senate version becomes law, there may be some lingering uncertainty as to the application of this provision to partnerships and foreign corporations until administrative guidance is issued.

The provision would be effective for tax years beginning after December 31, 2017.

The JCT estimates that this provision would increase revenues by approximately \$8.8 billion over 10 years.

KPMG observation

Although both the House bill and the Finance Committee bill include provisions aimed at disproportionate leverage in U.S. members of multinational groups, the Senate version raises substantially less revenue (\$8.8 billion) than the House version (\$34.2 billion) over the 10-year budgetary window. One reason for the difference may be that the mark refers to debt-equity ratios, while the House bill refers to EBIDTA ratios, which could have very different scaling effects. In addition, the Finance Committee bill is more generous by allowing an indefinite carryforward of all disallowed net interest expense.

Another likely reason for the difference in the revenue estimates, however, is that the House and Senate proposals on disproportionate indebtedness may both be scored after taking into account the House and Senate's respective proposals to modify section 163(j). Although both the House and Senate bills would apply new section 163(j) based on 30% of "adjusted taxable income," the Finance Committee bill would define adjusted taxable income without any addback for depreciation and amortization, making it a much tighter limit (as reflected in the revenue estimates for the House (\$171.7 billion) and Senate (\$308.1 billion) versions of new section 163(j)).

Adds limitations on income shifting through intangible property transfers

The Finance Committee bill would amend the definition of intangible property in section 936(h)(3)(B) (which applies for purposes of sections 367(d) and 482) to include workforce in place, goodwill, going-concern value, and "any similar item" the value of which is not attributable to tangible property or the services of an individual. The proposal also would remove the flush language of section 936(h)(3)(B), which limits section 936(h)(3)(B) to intangibles that have substantial value independent of the services of any individuals, to make clear that the source or amount of value of an intangible is not relevant to whether that type of intangible is within the scope of section 936(h)(3)(B).

Additionally, the proposal clarifies the authority of the Commissioner to specify the method used to value intangible property for purposes of both the section 367(d) outbound transfer rules and the section 482 intercompany pricing rules. Specifically, when multiple intangible properties are transferred in one or more transaction, the IRS may value the intangible properties on an aggregate basis when that achieves a more reliable

result. The proposal also would codify the realistic alternative principle, which generally looks to the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The provision would apply to transfers in tax years beginning after December 31, 2017. Additionally, the report explains that no inference is intended with respect to the application of section 936(h)(3)(B) or the Secretary to provide by regulation for such application on or before the date of enactment.

KPMG observation

Consistent with the provision discussed immediately above, which is designed to make it easier to bring intangible property back into the United States, this provision would make it more difficult for a U.S. person to transfer intangible property outbound without incurring tax. The provision also would resolve prospectively long-standing uncertainties regarding the scope of section 936(h)(3)(B) and, in particular, the application of section 367(d) to outbound transfers of goodwill, going concern value, and workforce in place. Although recent regulations under section 367 required that that outbound transfers of goodwill and going concern value are taxable under section 367(a) or (d), the IRS expressly declined to address whether goodwill, going concern value, and work force in place are section 936(h)(3)(B) intangibles.

Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities

The Finance Committee bill would disallow a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity.

A disqualified related-party amount is any interest or royalty paid or accrued to a related party if (i) there is no corresponding income inclusion to the related party under local tax law or (ii) such related party is allowed a deduction with respect to the payment under local tax law. A disqualified related-party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under section 951(a) (i.e., a “subpart F” inclusion). A related party for these purposes is determined by applying the rules of section 954(d)(3) to the payor (as opposed to the CFC referred to in such section).

A hybrid transaction is any transaction or instrument under which one or more payments are treated as interest or royalties for federal income tax purposes but are not treated as such under the local tax law of the recipient.

A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated

as fiscally transparent for foreign tax law purposes but not for federal income tax purposes (reverse hybrid entity).

The Finance Committee bill also would grant the Secretary authority to issue regulations or other guidance necessary or appropriate to carry out the purposes of the proposal and sets forth a broad list of issues such guidance may address. Such guidance may provide rules for the following: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity; (2) applying the proposal to foreign branches; (3) applying the proposal to certain structured transactions; (4) denying some or all a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%; (5) denying a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system that provides for the exclusion of a substantial portion of such amount; (6) determining the tax residence of a foreign entity; and (7) exceptions to the proposal's general rule.

The provision would be effective for tax years beginning after 2017 and does not appear to contain grandfathering rules.

The JCT did not separately score the provision. Instead, the provision was included as part of the estimated cost of the deduction for dividends received by domestic corporations from certain foreign corporations.

KPMG observation

The Finance Committee bill would attempt to neutralize the effects of hybrid mismatch arrangements by denying deductions for interest and royalty payments made to related parties under hybrid arrangements that give rise to income that is not taxed in any jurisdiction (stateless income). The House bill does not contain a similar proposal. However, similar proposals have been included as part of President Obama's FY 2017 Budget Proposal and in the recommendations issued pursuant to Action 2 of the OECD BEPS project (Recommendations).

The Finance Committee bill's provision is written broadly and would appear to apply to many of the transactions and structures addressed by the Recommendations including, the use of hybrid instruments and payments to and from reverse hybrids and disregarded payors. For example, an interest payment made with respect to a hybrid financial instrument held by a related party could be caught if there is no corresponding inclusion to the related party. Moreover, payments by a U.S. LLC that has elected corporate status for U.S. tax purposes to its foreign parent could be caught if the foreign parent does not have an income inclusion as a result of the U.S. LLC being treated as disregarded under the tax laws of the country of the foreign parent.

The Finance Committee bill does not appear to be limited to interest or royalties paid by a U.S. payor and may apply to payments made by a U.S. person, to a U.S. person, or between foreign related parties.

Other portions of the Recommendations may be implemented through Treasury Regulations. These provisions could include rules that apply to imported mismatch arrangements, branch structures, and deductible dividends that are excluded pursuant to a participation exemption.

Hybrid entities also potentially implicate the dual consolidated loss rules. Specifically, a domestic corporate owner of a foreign hybrid entity is subject to the dual consolidated loss rules, if the foreign hybrid entity incurs a loss for U.S. tax purposes. Neither the Finance Committee bill nor the House bill alters the dual consolidated loss rules. The House bill and the Finance Committee bill, however, include provisions that would create a special foreign branch loss recapture rule that in certain circumstances overlaps with the overall foreign loss recapture provision, the section 367 branch loss recapture provision, and the dual consolidated loss recapture provision. These provisions contain rules that coordinate section 91 recapture with overall foreign loss recapture and section 367 branch loss recapture, but the provisions do not address the coordination of section 91 recapture with the dual consolidated loss recapture provision.

Terminate special rules for domestic international sales corporations

The Finance Committee bill would terminate existing DISC elections and prohibit any new corporate elections to be treated as a DISC, thereby rendering moot the special rules in the Code for DISCs and IC-DISCs. Thus, corporations will no longer have access to the exemption from corporate level taxation allowed under the DISC rules. Individual shareholders of such former DISCs and IC-DISCs continue to be subject to shareholder-level taxation in respect of the earnings of the corporations, but with a new twist. Under a transition rule, shareholders of such former DISCs would be deemed to receive a distribution in the first tax year for which the termination is effective which—along with any future distributions out of the corporation's accumulated DISC income—would not qualify for the reduced rate of tax available to qualified dividend income under Code section 1(h)(11).

The proposal would prohibit any new corporate elections to be treated as a DISC, and terminate existing DISC elections that are in effect for the corporation's last tax year beginning in 2018. The termination is effective for the corporation's immediately succeeding tax year.

According to JCT, this provision would increase revenues by approximately \$5.3 billion over 10 years.

KPMG observation

Companies and their shareholders that have set up DISCs in order to benefit from the favorable regime should revisit their arrangements in light of the repeal and the unavailability of qualified dividend treatment going forward. The combined impacts of this provision could likely result in liquidation of many existing DISCs.

KPMG observation

The DISC regime was originally adopted in order to promote U.S. exports. The reduction in export incentives resulting from DISC repeal appears likely to be small in comparison to the Finance Committee bill's introduction of the deduction for foreign-derived intangible income, which would appear to have a positive effect on exports.

Surrogate foreign corporations not eligible for reduced rate on dividends

The Finance Committee bill's anti-base erosion provisions include a rule that prevents a dividend from a surrogate foreign corporation, which is not treated as a domestic corporation under section 7874(b), to an individual from qualifying for the reduced tax rate applicable to qualified dividends. This rule would be effective for dividends paid in tax years beginning after December 31, 2017.

KPMG observation

The Finance Committee bill's rule regarding dividends paid by surrogate foreign corporations would apply to *all existing and future* surrogate foreign corporations. Thus, the rule would apply to dividends from foreign corporations that are already surrogate foreign corporations, notwithstanding that the associated domestic entity acquisition was completed prior to the mark's introduction. The House bill does not include a similar provision.

Modifications related to foreign tax credit system*Repeal section 902 indirect foreign tax credits; determination of section 960 credit on a current-year basis*

A provision of the Finance Committee bill would repeal the deemed paid foreign tax credit under section 902 of the Code and retain but modify the deemed paid foreign tax credit under section 960 of the Code.

Section 902 of the Code deems a U.S. corporate shareholder of a 10% owned foreign corporation to have paid a portion of the foreign corporation's foreign income taxes when it receives or is deemed to receive a dividend from that foreign corporation. Section 960 of the Code provides a similar deemed paid credit for subpart F inclusions. Under the

proposal, the allowable credit under section 960 of the Code would be based on current-year taxes attributable to subpart F income rather than the “pooling” approach that applies currently under sections 902 and 960.

The Finance Committee provision would also provide rules applicable to foreign taxes attributable to distributions of previously taxed income (PTI), including from a lower-tier to an upper-tier CFC. These rules are not explained in any further detail, but appear to be based on similar rules in the House bill, under which these foreign taxes would be allowed as credits under section 960 in the year the PTI is distributed. The proposal grants the Secretary authority to promulgate regulations and guidance such that the amended section 960 credit would, as under current law, be computed separately for each category or “basket” of income under Code section 904(d).

The proposal would make conforming amendments to other Code provisions to reflect the repeal of Code section 902, including amending Code section 78 to treat the “gross-up” for deemed paid taxes as an additional section 951(a) inclusion rather than a dividend.

The amendments are proposed to be effective for tax years of foreign corporations beginning after 2017 and to tax years of United States shareholders with or within which such tax years of foreign corporations end.

KPMG observation

These revisions to the foreign tax rules are essentially identical to the proposals in the “2014 tax reform proposal” and the House bill. The repeal of section 902 of the Code would have significant consequences for domestic corporations currently eligible to claim section 902 deemed-paid credits with respect to dividends from 10%-owned foreign corporations that are not CFCs because foreign income taxes paid or accrued by such corporations could no longer be claimed as FTCs. Moreover, the change from the current pooling regime to a current-year foreign tax regime could also significantly affect the foreign tax credit calculation, as the pooling regime serves to blend effective foreign tax rates that may differ from year to year due to U.S. and foreign timing differences and rate changes.

Separate foreign tax credit limitation basket for foreign branch income

The proposal creates a new tax credit limitation basket for foreign branch income. Under the proposal, foreign branch income is a U.S. person’s business profits attributable to one or more qualified business units (QBUs) in one or more countries. Generally, a QBU is defined in section 989 of the Code as “any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.” The proposal grants the Secretary the authority to establish rules determining what constitutes “business profits,” however, the proposal explicitly excludes passive income from the definition.

This provision would be effective for tax years beginning after 2017.

KPMG observation

Similar to creating a separate basket for GILTI, as discussed below, this proposal would operate to prevent cross-crediting of foreign taxes attributable to low-tax subpart F income with those attributable to high-tax branch income.

Acceleration of election to allocate interest on a worldwide basis

The provision would accelerate the effective date of Code section 864(f), which is currently scheduled to take effect for tax years beginning after December 31st, 2020. The proposal would have section 864(f) take effect for tax years beginning after December 31st, 2017. Once effective, section 864(f) would permit taxpayers to apportion the interest expense of U.S. members of a worldwide affiliated group on a worldwide basis. Worldwide affiliated group is defined for this purpose by reference to section 1504(a) of the Code, but without taking sections 1504(b)(2) and (4) into account, and includes CFCs that are 80% or more owned directly or indirectly, applying section 958(a) with modifications, by domestic members of such group.

Currently, section 864(e) of the Code governs the allocation and apportionment of interest expense by members of an affiliated group. Under section 864(e), the interest expense apportionment of non-U.S. members of the affiliated group is not taken into account when apportioning interest expense of group members between U.S. and foreign source income. As a result the section 864(e) allocation method may cause an over-allocation of interest expense to foreign-source income, thereby reducing foreign source taxable income and limiting the foreign tax credit. Under the proposal, the common U.S. parent of a worldwide affiliated group could elect to make a “worldwide group election.” Under the worldwide group election, the taxable income of domestic members of the worldwide affiliated group would be determined by allocating and apportioning the interest expense of each such member as if all members of such worldwide group were a single corporation. The worldwide apportionment formula would adjust the amount of interest expense apportioned to foreign sources by domestic members of such group to account for interest apportioned to foreign sources by CFCs included in the worldwide group. As a result, the amount of interest expense allocated to foreign source income may be lower than if section 864(e) were applied and, therefore, an increase in foreign source taxable income and the foreign tax credit limitation may result.

Section 864(f) also provides special rules and an election for certain financial institutions included in a worldwide group.

This provision would be effective for tax years beginning after 2017.

According to JCT, this provision would decrease revenues by approximately \$2.0 billion over 10 years.

KPMG observation

The proposal permitting taxpayers to elect to allocate interest on a worldwide basis will likely result in the availability of a higher foreign tax credit limitation for certain taxpayers and, therefore, the ability to credit more U.S. taxes with foreign taxes paid or accrued than would be permitted if section 864(e) applied.

Determine source of income from sales of inventory solely on basis of production activities

The proposal would revise the current general rule under Code section 863(b), which sources income from inventory property produced in one jurisdiction and sold in another jurisdiction by allocating 50% of sales income to the place of production and 50% to the place of sale (determined based on title passage). Under the proposed change, income from inventory sales would be sourced entirely based on the place of production. Thus, if inventory property is produced in the United States and sold outside the United States, sales income would be 100% U.S. source. If inventory property is produced partly within and partly without the United States, income from the sales would be partly U.S. source and partly foreign source.

According to JCT, this provision would increase revenues by approximately \$500 million over 10 years.

This provision would be effective for tax years beginning after 2017.

KPMG observation

The proposed change, which is identical to the proposal in the 2014 tax reform proposal and the proposal in the House bill, eliminates the beneficial title passage rule and replaces it with a rule that is meant to reflect solely the economics of production. It could, though, have the unintended result of encouraging companies to expand foreign production.

Limit foreign tax credits for global intangible low-taxed income

In addition, the proposal would add a new FTC basket for taxes associated with “global intangible low-taxed” income. For more details regarding those rules see the discussion of regarding global intangible low-taxed income in the “Prevention of Base Erosion” section above.

Inbound provisions

Add base erosion and anti-abuse tax

The final sentence in the “Unified Framework” released by Republican leadership on September 27 was an opaque statement that “the committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.” Both the House bill and the Finance Committee bill include a number of international tax incentives and anti-base erosion provisions aimed at achieving this goal. Significantly, each mark includes a novel levy focused on deductible payments by large U.S. groups to foreign affiliates. In the House bill, this was the Sec. 4303 Excise Tax on “Specified Amounts.” The Finance Committee bill’s corollary proposal is a new base-erosion-focused minimum tax (the “BEMT”) that differs in several key respects from the House proposal.

Scope—Applicable taxpayers making base erosion payments

The BEMT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least \$500 million of annual gross receipts (over a three-year averaging period), and which have a “base erosion percentage” (discussed below) of 4% or higher for the tax year. The provision also applies to foreign corporations engaged in a U.S. trade or business for purposes of their effectively connected income tax liability.

The targeted base erosion payments generally are amounts paid or incurred by the taxpayer to foreign related parties for which a *deduction is allowable*, including amounts paid in connection with the acquisition of *depreciable or amortizable* property from the related party. For taxpayers that are part of an “inverted” group, determined by reference to section 7874, base erosion payments also include “any amount that constitutes reductions in gross receipts” of the taxpayer when paid to the surrogate foreign corporation or any member of its expanded affiliated group.

The definition of a foreign related party is drawn from current section 6038A and includes any 25% foreign shareholder of the taxpayer, related persons thereto, and any other person related to the taxpayer under the section 482 rules.

KPMG observation

The inclusion of cross-border product flows where the payments were recovered through COGS was a surprising feature of the Excise Tax. Under the BEMT, however, U.S. payments treated as COGS do not appear to be within scope, except for inverted groups (which are given more restrictive treatment in a number of the Finance Committee bill provisions). The treatment of cross-border payments for COGS is a key difference between the affected classes of taxpayers for the two proposals. For example, payments

for inventory by foreign-owned U.S. distributors of goods that are manufactured outside the United States would be subject to the Excise Tax but would not be subject to the BEMT.

The BEMT's scope is broader in some respects than the Excise Tax, however, in that the BEMT does not exempt deductible payments of interest, and does not exempt services provided at cost. There also is no specific exception for payments made by U.S. multinationals' domestic groups to their CFCs. Thus, absent coordination, payments that are treated as full inclusion subpart F income or as GILTI could also be fully subject to the BEMT, even though there may be no net tax benefit for payments subject to full inclusion and only a reduced tax benefit for payments included in GILTI. Nevertheless, the threshold of deductible payments that is necessary for the BEMT to become a positive tax liability would seem unlikely to be met for many U.S.-headquartered companies.

The BEMT may significantly affect many inbound companies, and furthermore would affect certain industries disproportionately. As just one example, the proposal would have an economic impact on related-party cross border reinsurance, and therefore would significantly affect insurance companies that include off-shore reinsurance to an affiliated entity as an integral part of their business model.

Base erosion payments are subject to the provision when they give rise to a "base erosion tax benefit," meaning that a deduction is allowed for the tax year. If base erosion payments form part of a net operating loss ("NOL"), the base erosion tax benefit coincides with the section 172 deduction in the carryback or carryover year, as modified by the Finance Committee bill.

For base erosion payments that are subject to Chapter 3 withholding, the payment is not subject to the rule (that is, it is not added back to modified taxable income, as discussed below). For payments that are subject to a reduced rate of withholding under a Treaty, the exclusion is done proportionately in comparison to the statutory withholding rate.

The base erosion percentage used for the 4% threshold requirement, and for the portion of an NOL deduction that is taken into account, is determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the tax year by the aggregate amount of the deductions allowable to the taxpayer for the year, but excluding NOLs, the participation exemption, and the deduction allowed under new section 250 (presumably the deduction for foreign-derived intangible income).

KPMG observation

Although not explicitly stated in the mark, the connection to the tax benefit with the allowed deduction appears to mean that for base erosion payments that are capitalized into depreciable or amortizable basis, the tax benefit occurs as the capitalized costs are recovered.

Furthermore, the focus on allowed deductions suggests that an amount must otherwise be deductible after the application of other limitations before it is taken into account as a base erosion tax benefit. For example, presumably only the net deductible amount of interest paid by the U.S. taxpayer to foreign affiliates, after application of the Finance Committee bill's proposed new thin capitalization rules and after satisfying current code section 267(a)(3), would be considered to give rise to a base erosion tax benefit.

Insofar as the provision intends to treat payments giving rise to COGS for taxpayers within inverted groups as base erosion payments, the bill's description does not elaborate on how this treatment would occur, given that COGS are not treated as allowable deductions but rather as reductions from gross receipts that are taken into account in computing gross income. It seems reasonable to assume that the tax benefit would be taken into account in the year that inventory accounting allows the COGS to offset gross receipts.

BEMT computation

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount ("BEMTA"). The BEMTA equals the excess of 10% of the taxpayer's modified taxable income ("MTI") for the year, over an amount equal to the pre-credit regular income tax liability reduced (but not below zero) by any credits, other than the research credit, allowed in that year.

MTI is the taxpayer's taxable income, with the base erosion tax benefit amount (including the base erosion percentage of a NOL deduction) added back.

KPMG observation

The BEMTA formula appears to allow taxpayers to retain the benefit of the research credit in their overall tax liability computation. The following example may help illustrate the formula's application.

Assume the ABC U.S. Consolidated Group ("ABC") has pre-credit regular tax liability of \$20,000 (corresponding to \$100,000 of taxable income after the 20% corporate income tax rate takes effect). ABC claims \$5,000 of tax credits overall, of which \$3,000 constitute research credits. Thus, the "floor" that the BEMTA must cross is $\$20,000 - (\$5,000 - \$3,000) = \$18,000$. For companies that are taxpayers, this formula thus effectively adds back the research credit [\$3,000] to the otherwise final tax liability [\$15,000].

The BEMT would be owed to the extent that ABC's MTI equaled more than \$180,000 (that is, $\$18,000 \times 10$, or $\times 1.1$). Stated differently, ABC would have to deduct more than \$80,000 of base erosion tax benefits for the year to be subject to the BEMT.

The foregoing illustrates that, with a 20% corporate tax rate and absent the research credit allowance, the BEMT is only due when the taxpayer more than halves its taxable income through base erosion deductions.

The November 14 Chairman's modifications made two changes, subject to the attainment of certain revenue targets, that broaden the base of the BEMT for tax years beginning after December 31, 2025: (i) the 10% of MTI input will increase to 12.5% of MTI; and (ii) the tax liability against which 12.5% of MTI is compared is simply regular income tax liability minus all credits, which appears to remove the previously retained benefit of the research credit. These changes are estimated to yield an additional \$14.1 billion in revenue over the 10-year window.

Reporting and penalties

The provision would introduce new reporting requirements under the existing Code section 6038A (Form 5472) regime to collect information regarding applicable taxpayers' base erosion payments. The provision would also increase that reporting regime's existing \$10,000 penalty to \$25,000.

The provision applies to payments paid or accrued in tax years beginning after December 31, 2017.

The provision, after the Chairman's modification, is estimated to increase revenues by approximately \$137.6 billion over 10 years. The original estimate was \$123.5 billion.

KPMG observation

The BEMT is a significant new proposal and revenue raiser in the Finance Committee bill's international proposals. If enacted, it would operate in tandem with the new interest deduction limitations, and the disallowance for payments involving hybrid transactions and hybrid entities, to significantly curtail the scope of deductible payments that can be made by U.S. groups to their foreign affiliates.

By implementing the base erosion levy as a new minimum tax on the U.S. taxpayer, the proposal may avoid the tax treaty override and trade agreement concerns that were raised with respect to the Excise Tax. The Excise Tax's effectively connected income election arguably reflects an assertion of taxing jurisdiction over profits currently seen as attributable to non-U.S. members of a companies' global supply chain. By comparison, the BEMT is a less drastic change in U.S. tax policy. It may, however, still raise issues regarding the non-discrimination clauses contained in most U.S. tax treaties.

Although both the House and the Finance Committee bill clearly set out to address erosion of the U.S. tax base via cross-border related party payments, they use very different mechanisms that likely would have widely varying effects across the universe of

taxpayers. The two chambers will need to reconcile the scope and policy differences between these two base erosion provisions.

Other provisions

Tax passenger cruise gross income of foreign corporations and nonresident alien individuals

The proposal would modify the taxation of income earned from the transportation of passengers aboard cruise ships on “covered voyages” (as defined in Code section 4472).

Ordinarily, U.S.-source income derived by foreign ship operators or lessors for transporting passengers and goods in international traffic (meaning the voyage begins or ends within the United States, but not both) is not subject to tax if the country of the foreign corporation’s organization provides a “reciprocal exemption.” Cruise ship voyages that begin at a U.S. port and end at a foreign port, or vice versa, thus qualify for this standard.

If a reciprocal exemption does not apply, then typically a 4% excise tax on a specified amount of income is imposed, in lieu of the traditional inbound taxation rules for service providers. The excise tax does not apply, however, and instead the relevant income is treated as effectively connected, when the foreign ship operator has a fixed place of business in the United States that is involved with earning the transportation income, and substantially all of the corporation’s transportation income is attributable to regularly scheduled transportation.

The proposal would remove passenger cruise transportation income from the special inbound shipping tax regime and instead treat a portion of it as effectively connected income, even if the foreign corporation does not have a U.S. fixed base or sufficient regularly scheduled transportation.

This provision would be effective for tax years beginning after 2017.

According to JCT, this provision would increase revenues by approximately \$700 million over 10 years.

Modify insurance exception to the passive foreign investment company rules

The provision in the Finance Committee bill appears to be materially the same as section 4501 of the House bill, and has the same effective date and revenue effect.

Current law contains an exception from passive income that prevents certain investment income derived from the active conduct of an insurance business from causing a foreign corporation to be a PFIC. As under section 4501 of the House bill, this exception in the PFIC rules would be modified to apply only to a foreign corporation whose applicable

insurance liabilities constitute more than 25% of its total assets as reported on the corporation's applicable financial statement for the last year ending with or within the tax year. Applicable liabilities of any property and casualty or life insurance business include loss and loss adjustment expenses and certain reserves, but do not include unearned premium reserves.

An applicable financial statement is a statement for financial reporting purposes that is made on the basis of generally accepted accounting principles (GAAP), on the basis of international financial reporting standards (IFRS) if no GAAP statement is available, or, "except as otherwise provided by the Secretary in regulations," on the basis of the annual statement required to be filed with the applicable insurance regulatory body, but only if neither a GAAP nor IFRS statement is available. Unless otherwise provided in regulations, GAAP means U.S. GAAP.

Like section 4501, the Finance Committee bill provides potential relief to a foreign corporation that cannot meet the new 25% test by giving the Secretary regulatory authority to allow a U.S. person owning stock of such a foreign corporation to elect to treat it as a qualifying insurance company if (1) its applicable liabilities equal at least 10% of its assets, and, (2) (a) the foreign corporation is predominantly engaged in an insurance business, and (b) the failure to satisfy the greater than 25% threshold is due solely to run-off-related or rating-related circumstances involving such insurance business.

The provision would apply to tax years (presumably of foreign corporations being tested for PFIC status) beginning after December 31, 2017.

The JCT has estimated that this provision also would increase revenues by approximately \$1.1 billion over 10 years.

KPMG observation

This provision largely tracks prior legislative proposals that were described as addressing a perceived abuse whereby some insurance activities were used to shelter large investments. The change may also have impacts on non-U.S. insurance companies that insure long-tail and catastrophic risks.

U.S. persons owning stock of a corporation treated as a PFIC because it is ineligible for the active insurance exception in Code section 1297(b)(2)(B) would be required to begin filing Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to consider available PFIC-related elections.

Under current law (Code section 6501(c)(8)), a U.S. person that fails to file Form 8621 for a year generally would have the statute of limitations for its tax return for that year kept open until three years after the U.S. person furnishes the required information to the IRS.

Like section 4501 of the House bill, the provision in the Finance Committee bill also could require the Department of the Treasury to issue new regulations, and the IRS to amend Form 8621, for taxpayers to take advantage of the election it would provide to U.S. shareholders of certain affected foreign corporations that fail the 25% liabilities test.

Repeal fair market value method of interest expense apportionment

The proposal would require taxpayers to allocate and apportion interest expense of members of an affiliated group (or, presumably, a worldwide group if elected pursuant to section 864(f)) using the adjusted basis of assets and would prohibit the use of the fair market value method.

According to JCT, this provision would increase revenues by approximately \$200 million over 10 years.

This provision would be effective for tax years beginning after 2017.

KPMG observation

Taxpayers that currently use the fair market value method to value assets when allocating interest expense will be required to switch to the adjusted basis or “tax book value” method. Such a switch could have a dramatic effect on the foreign source income calculation for certain taxpayers.

Modify source rules involving possessions

The Chairman's modifications would modify two Code sections that have an impact on citizens and residents of the U.S. Virgin Islands as well as citizens and residents of the United States who have income from sources within the U.S. Virgin Islands.

The sourcing rules that apply to determine whether the income of U.S. citizens and residents is possession source generally follow the principles for determining whether income is U.S. source. Code section 937(b) has a rule specifying that, except as provided in regulations, any income treated as income from sources within the United States or as effectively connected with the conduct of a trade or business within the United States is not treated as income from sources within the possession or as effectively connected with the conduct of a trade or business within the possession. The Finance Committee bill would modify Code section 937(b)(2) to scale back this limitation so that only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business would be removed from possessions source income.

In addition, the provision would modify the Code section describing the source rules for personal property sales. Code section 865 would be modified to provide that capital gains income earned by a U.S. Virgin Islands resident would be deemed to constitute U.S.

Virgin Islands source income regardless of the tax rate imposed by the U.S. Virgin Islands government.

The proposal would be effective for tax years beginning after December 31, 2018.

The JCT has estimated that the proposed provision would decrease revenue by approximately \$600 million over a 10-year period.

Repeal exclusion applicable to certain passenger aircraft operated by a foreign corporation

The Chairman's modifications added a new provision that would layer on additional requirements to the reciprocal exemption from U.S. tax for gross income derived by a foreign corporation from the international operation of an aircraft. Under current rules, an exemption from U.S. tax is provided for transportation income of foreign persons from countries that extend reciprocal relief to U.S. persons. The Finance Committee bill would modify Code section 883(a)(2) so that the exemption would not apply to income from the international operation of an aircraft by a foreign corporation headquartered in a foreign country that does not have an income tax treaty with the United States and that has fewer than two arrivals and departures, per week, from major passenger airline carriers headquartered in the United States.

The proposal would be effective for tax years beginning after December 31, 2017.

The JCT has estimated that the proposed rate structure would increase revenues by approximately \$200 million over a 10 year period.

Modify Code section 4985 excise tax

The Chairman's modifications would increase the Code section 4985 excise tax rate from 15% to 20%. This excise tax applies when a domestic corporation becomes an expatriated entity under section 7874 in a transaction that is taxable to the domestic corporation's shareholders, and is imposed on certain stock-based compensation directly or indirectly held by or for the benefit of certain "insiders" of the domestic corporation or a member of its expanded affiliated group and the family members of these insiders.

The JCT has estimated that the proposed rate structure would increase revenues by approximately \$100 million over a 10-year period.

CRAFT beverages/excise taxes on beer, wine, and distilled spirits

The Finance Committee bill would make numerous temporary changes to the taxes imposed on beer, wine, and distilled spirits. The JCT has estimated that these proposals would decrease revenues by approximately \$4.2 billion over 10 years. These provisions would sunset after 2019.

KPMG observation

The House bill does not include similar provisions. The Finance Committee provisions are in line with the Craft Beverage Modernization and Tax Reform Act of 2017, first introduced on January 30, 2017.

Exempt the aging period of beer, wine and spirits from UNICAP rules related to interest

The Uniform Capitalization (“UNICAP”) rules under section 263A require certain direct and indirect costs allocable to real or tangible personal property produced (or acquired for resale) to be included in inventory or capitalized into the basis of the related property. In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property’s production period, and that is allocable to property which either 1) is real property or property with a class life of at least 20 years, 2) has an estimated production period exceeding two years, or 3) has an estimated production period exceed one year and a cost exceeding \$1,000,000.

In the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period. The Finance Committee bill would exclude the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the provision, producers of beer, wine, and distilled spirits would be able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

This provision would be effective for interest costs paid or incurred after December 31, 2017 and would sunset for tax years beginning after December 31, 2019.

Reduced rate of excise tax on beer

The Finance Committee bill would reduce the amount of federal excise tax imposed on brewers and importers of beer. The Finance Committee bill would reduce the tax on beer from \$18 per barrel to \$16 per barrel on the first six million barrels brewed by the brewer

or imported by the importer. Beer brewed or imported in excess of the six million barrels would be taxed at \$18 per barrel.

For small brewers producing less than 2 million barrels of beer, tax would be reduced from \$7 per barrel to \$3.50 per barrel for the first 60,000 barrels. The additional barrels would be taxed at \$16 per barrel.

Special rules apply for determining controlled groups and allocation of the reduced tax rates among members of the controlled group.

Moreover, the mark discusses additional rules related to foreign brewers and the assignment of the reduced rate of tax to importers of foreign brewed beer.

This provision would apply to beer removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would provide a two-year reduced rate of tax for both small and large brewers and would allow foreign brewers to assign such credit to importers if conditions are met.

Simplification of rules regarding records, statements and returns

The Finance Committee bill directs the Secretary to permit persons subject to section 5555 to “employ a unified system for any records, statements, and returns required to be kept.” Section 5555 requires the collection of certain records, statements, returns and compliance, as prescribed by the Secretary.

This provision would apply to calendar quarters beginning after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

Transfers of beer in bond

The Finance Committee bill would allow for more situations in which beer may be transferred tax free under bond by modifying the rules of section 5414. Under the provision, brewers would be able to transfer beer from one brewery to another under any of the following situations:

- The breweries are owned by the same person (existing law)
- One brewery owns a controlling interest in the other (new)
- The same person or persons have a controlling interest in both breweries (new)

- The proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of tax (new)

This provision would apply to calendar quarters beginning after December 31, 2017 and expires for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would allow more types of tax-free transfers of beer under bond for a two-year period, essentially providing for a deferral of tax due if conditions are met. Most importantly, it would allow for a transfer under bond of beer between unrelated proprietors.

Reduced rate of tax on certain wine

The Finance Committee bill would modify the section 5041(c) credit for small domestic producers of wine. The Finance Committee bill would allow the credit to be claimed by foreign and domestic producers of wine, regardless of the gallons of wine produced. The Finance Committee bill would also allow the credit for sparkling wine producers.

Under the Finance Committee bill, the credit for wine produced in, or imported into, the United States during the calendar year would be:

- \$1.00 per wine gallon for the first 30,000 wine gallons of wine; plus
- \$0.90 per wine gallon for the next 100,000 wine gallons of wine; plus
- \$0.535 per wine gallon on the next 620,000 wine gallons of wine.

The Finance Committee bill also provides rules for allowing foreign producers of wine to assign the credit to importers of the wine.

The provision would apply to wine removed after December 31, 2017 and expires for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would essentially provide a two-year rate reduction for all foreign and domestic producers of wine, including sparkling wine, regardless of the number of wine gallons produced. Moreover, it would allow foreign producers to assign such credit to importers if conditions are met.

Adjust alcohol content level of wine for application of excise taxes

The Finance Committee bill would modify the alcohol-by-volume levels of the first two tiers of federal excise tax on wine. Generally, under section 5041, wine with an alcohol content of not more than 14% alcohol is taxed at a rate of \$1.07 per wine gallon and wine more than 14% but not more than 21% alcohol is taxed at a rate of \$1.57 per gallon. The Finance Committee bill would change section 5041 such that wine with an alcohol content of not more than 16% alcohol would be taxed at the \$1.07 per wine gallon rate.

This provision would apply to wine removed after December 31, 2017 and expires for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would provide a two-year, \$.50 per wine gallon rate reduction for still wines with an alcohol content of more than 14% but less than 16% alcohol.

Reduced rate of tax on mead and certain carbonated wines

The Finance Committee bill would reduce the rate of tax for mead and certain sparkling wine. Currently sparkling wines are generally taxed at a rate of \$3.40 per wine gallon and artificially carbonated wines are taxed at a rate of \$3.30 per wine gallon. Under the Finance Committee bill, mead and certain sparkling wine would be taxed at the lowest rate applicable to “still wine” which is currently a rate of \$1.07 per wine gallon of wine.

“Mead” is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine, which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5% alcohol-by-volume.

The sparkling wines eligible to be taxed at the preferential rate are wines that contain no more than 0.64 grams of carbon dioxide per hundred milliliters of wine, which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape and which contain less than 8.5% alcohol-by-volume.

This provision would apply to wine removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would provide a two-year significant rate reduction for mead and certain sparkling wines that contain an alcohol content of less than 8.5% alcohol-by-volume.

Reduced excise tax rates on distilled spirits

Under existing section 5001, all distilled spirits are taxed at a rate of \$13.50 per proof gallon. The Finance Committee bill would institute a tiered rate for distilled spirits. The Finance Committee bill would tax the first 100,000 proof gallons of distilled spirits at a rate of \$2.70 per proof gallon. The tax rate for proof gallons greater than 100,000 but less than 22,130,000 proof gallons would be \$13.34 per proof gallon, and the rate for 22,130,000 proof gallons or more would be \$13.50 per proof gallon.

This provision would apply to distilled spirits removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would provide a two-year significant rate reduction for distilled spirit producers and importers.

Allow transfer of bonded spirits in bottles

The Finance Committee bill would expand allowable tax-free transfers in bond of distilled spirits to distilled spirits that are not packaged in bulk containers.

Generally under current law, tax is imposed on distilled spirits upon removal from the distilled spirits plant. An exception is that bulk distilled spirits may be transferred without payment of tax if the transfer is under bond between bonded premises and in containers that are at least one gallon; that is, a bulk container.

This provision would apply to distilled spirits removed after December 31, 2017 and expires for tax years beginning after December 31, 2019.

KPMG observation

The Finance Committee bill would allow transfers of distilled spirits in bottles to be made tax-free under bond for two years.

Procedural provisions

Matching grants for return preparation programs for low-income taxpayers

The IRS is authorized under current law to spend funds from taxpayer service appropriations for a volunteer income tax assistance matching grant program (VITA) to provide tax preparation services for low-income and underserved populations.

The Finance Committee bill codifies the VITA program, prescribes the requirements for qualifying programs, specifies the types of costs for which grant monies may be used, and specifies the categories of taxpayers eligible for assistance. In addition, this provision allocates up to \$30 million from otherwise appropriated funds for matching grants under the program.

The JCT estimated that the provision would have no revenue effect.

KPMG observation

This provision was in the modified mark. Because this provision has no revenue effect, budget reconciliation procedural issues might be raised on the Senate floor.

A similar provision is not in the House bill.

Sense of the Senate regarding reinstating appropriate IRS funding level

The Finance bill expresses the Senate's opinion that politically motivated cuts to the Internal Revenue Service's budget diminishes the Service's ability to enforce the tax laws, to provide adequate taxpayer service, and to help ensure adequate protection of taxpayer information. In addition, the modified mark indicates the Senate's view that politically motivated IRS budget cuts are counterproductive to deficit reduction.

The JCT has estimated that the provision has no revenue effect.

KPMG observation

This provision was in the modified mark. A similar provision is not in the House bill.

A "sense of the Senate" provision merely express the opinion of the Senate. If included in enacted legislation, it has no formal effect on public policy and does not have the force of law. In addition, because it has no revenue effect, budget reconciliation procedural issues might be raised on the Senate floor.

From fiscal years 2010 to 2015, the entire operating budget for the IRS was cut from \$12.1 billion to \$10.9 billion, without adjusting for inflation. Funding was increased to \$11.2 billion for fiscal years 2016 and 2017.

Codification of the IRS Free File Program

The Finance Committee bill would codify and make permanent the IRS Free File Program. The Free File program is a partnership between the IRS and the Free File Alliance, a group of industry-leading private-sector tax preparation companies that have agreed to provide free commercial online tax preparation and electronic filing. The program was first

established by agreement executed in 2002, and has been continually extended by agreement thereafter.

The JCT has estimated that this provision would have no revenue effect.

KPMG observation

This provision was not in the House bill. It was added to the Finance Committee bill by the manager's amendment. Because it has no revenue effect, budget reconciliation procedural issues might be raised on the Senate floor.

Use of Free File Software was limited to taxpayers with adjusted gross income of \$64,000 or less for 2016.

Uniform tax treatment of attorney fees and court costs in connection with whistleblower awards

The Finance Committee bill would provide an above-the-line deduction for attorney fees and courts costs paid by, or on behalf of, a taxpayer in connection with any action involving a claim under State False Claims Acts, the SEC whistleblower program, and the Commodity Futures Trading Commission whistleblower program.

The JCT has estimated that this provision would lose approximately \$100 million over a 10-year period. The JCT table also indicates that this provision would be sunsetted after 2025.

KPMG observation

This provision was added by the manager's amendment.

Whistleblower claims are brought under a variety of federal and state statutes. The statute under which the claim is made can materially affect its Federal income tax treatment. Not all claims qualify to have legal fees deductible "above the line," thus, allowing the whistleblower to not pay any tax on the legal fees. Otherwise, the whistleblower has to claim a miscellaneous itemized deduction, which is subject to a number of limits. This problem was made clear by in in *Commissioner v. Banks*, 543 U.S. 426 (2005), where the Supreme Court held the plaintiff's entire recovery of economic damages for a claim under Title VII of the Civil Rights Act of 1964 was taxable income, including the portion paid to the plaintiff's attorney under a contingent fee agreement.

The American Jobs Creation Act of 2004, (P.L. 108-357) section 703, enacted Reg. section 62(a)(20) to allow an above-the-line deduction for attorney fees and court costs paid by an individual "in connection with any action involving a claim of unlawful discrimination," within the meaning of section 62(e). The Tax Relief and Health Care Act

of 2006 (P.L. 109-432), section 406, enacted Reg. section 62(a)(21) to allow an above-the-line deduction for attorney fees and court costs paid by an individual in connection with a whistleblower award under section 7623(b). This provision is limited in application, and generally does not apply to other fees related to whistleblower awards outside of section 7623(b).

However, no provision under section 62(a) explicitly includes an above-the-line deduction for attorney fees and court costs paid by an individual for a whistleblower claim under the federal False Claims Act, the SEC whistleblower program, and the Commodity Futures Trading Commission whistleblower program.

Improvement of the IRS whistleblower program

The Finance Committee bill would amend section 7623(b) to define collected proceeds eligible for awards to whistleblowers to include: (1) penalties, interest, additions to tax, and additional amounts, and (2) any proceeds under enforcement programs that the Treasury has delegated to the IRS the authority to administer, enforce, or investigate, including criminal fines and civil forfeitures, and violations of reporting requirements. This definition would also be used to determine eligibility for the enhanced reward program under which proceeds and additional amounts in dispute exceed \$2,000,000.

KPMG observation

This provision was added in the manager's amendment. It may have been added because of the IRS's litigating position in *Smith v. Commissioner*, 148 T.C. No. 21 (2017), in which the Tax Court held that the "amounts in dispute" referenced in the section 7623(b)(5)(B) threshold (\$2 million) are the total amount of the liability that the IRS proposed with respect to a taxpayer's examination that was commenced using the information provided by a whistleblower, and are not limited as the IRS argued to the part of the collected proceeds attributable only to the specific information provided or allegations made, by the whistleblower.

Revenue-dependent repeal prospective reporting provisions

As a result of the modified mark, six revenue-raising provisions in the Finance Committee bill with prospective effective dates could be repealed if cumulative aggregate on-budget federal revenue from all sources of the U.S. government for the period beginning October 1, 2017, and ending September 30, 2016, exceed a certain dollar amount by more than a certain amount. These six provisions are:

- Further decreasing the newly-created limitation on net operating loss (NOL) deductions of 90% of taxable income beginning in 2018 to 80% after 2022

- Disallowance of employer deduction for meals provided for the convenience of the employer on the employer's business premises effective after 2025
- Certain changes made by the modified mark to the deductions for global intangible low-taxed income (GILTI) for tax years beginning after 2025
- Certain changes made by the modified mark to foreign-derived intangible income and to certain base erosion payments effective after 2025
- Certain modifications to the tax on base erosion payments of some taxpayers
- Amortization of R&E expenditures (including reporting requirements) effective after 2025

The manager's amendment added reporting requirements, described as:

a reporting requirement for research and experimental expenditures in tax years beginning after December 31, 2024, detailed reporting of costs of goods sold, related party payments broken down by type and separately stated, reporting with respect to all foreign derived intangible income, and a certification under penalties of perjury that income that qualifies for the deduction does not relate to the sale of products into the United States.

Penalties would apply for failure to make the required information returns.

Modification to user fee requirements for installment agreements

The Finance Committee bill would limit the ability of the IRS to increase from current levels user fees charged when a taxpayer enters into an installment agreement to pay tax liabilities. It would also assist low-income taxpayers (incomes below 250% of Federal poverty guidelines) to either avoid the user fee by making automated installment agreement payments via a debit account, or recoup the user fee if unable to make automated payments but successfully complete the required installment agreement.

The JCT estimated that this provision would result in a gain in revenue of less than \$50 million over a 10-year period.

KPMG observation

This provision was not in the House bill.

REITs

KPMG observation

The Finance Committee bill would provide a deduction to noncorporate domestic taxpayers of 17.4% on dividends paid by a REIT that are neither capital gain dividends nor are eligible for treatment as “qualified dividend income.” This would provide parity between the treatment under the Finance Committee bill of ordinary REIT dividends and “domestic qualified business income” (setting aside the 50% wage-based limitation described above). The Finance Committee bill would also provide for a maximum marginal tax rate on ordinary income (other than certain “qualified domestic business income”) of 38.5%. For noncorporate domestic taxpayers, this would reduce the maximum marginal tax rate on ordinary REIT dividends to approximately 34.9%, including the 3.8% Medicare tax. The House bill, by contrast, proposes a maximum rate of 28.8% on REIT dividends and active business income earned through passthrough entities.

As with the House bill, the Finance Committee bill would reduce the effective tax rate on dividends paid by a domestic C corporation to noncorporate domestic taxpayers to approximately 39% (including 20% at the corporate level) once the reduction in the maximum corporate tax rate becomes effective (see below). The effective tax rate under the Finance Committee bill on ordinary dividends paid by REITs to noncorporate domestic taxpayers would appear to decrease from 43.4% to approximately 34.9%. This is a smaller disparity than would exist under either the House bill or current law. Under both the Finance Committee bill and House bill, the disparity in tax rate for these taxpayers for distributions attributable to capital gain generally would be slightly more than 15% (approximately 39% for C corporations, and 23.8% for REITs). The rates described above relating to the Finance Committee bill assume that the limitation on the 17.4% deduction (i.e., to 50% of the taxpayer’s allocable share of wage expense) that applies to investors in partnerships, S corporations, and sole proprietorships would not apply to limit the 17.4% deduction as applied to ordinary dividends from REITs. This remains, however, subject to clarification in any legislative language reflecting the Finance Committee bill.

Importantly, the Finance Committee bill’s reduction in corporate tax rate would apply to tax years beginning after 2018, and would be permanent. The 17.4% deduction described above (and the changes in individual income tax brackets), however, generally would apply to tax years beginning after 2017. In addition, both this deduction and the proposed rate structure for individuals (which, among other things, would reduce the maximum individual income tax rate from 39.6% to 38.5% (not taking into account the 3.8% Medicare tax)) would sunset for tax years beginning after 2025. Under the Finance Committee bill, therefore, for tax years beginning after 2025, the effective tax rate for ordinary dividend income of noncorporate domestic taxpayers from C corporations would remain approximately 39%, while the effective tax rate for dividend income of noncorporate domestic taxpayers would increase to 43.4%; the effective rates for capital gain income generally would not change as a result of a sunset.

Foreign income

As described elsewhere, the changes proposed by the Finance Committee bill to the taxation of U.S. taxpayers' foreign income would be substantial, and would have an effect on REITs that invest overseas. Domestic corporate taxpayers generally would be able to fully deduct the "foreign-source portion" of dividends from foreign corporations (other than certain passive foreign investment corporations) in which they are "United States shareholders" (i.e., they hold a 10%-or-greater voting interest, determined taking into account applicable attribution rules). A similar proposal is included in the House bill. Under current law, however, seemingly left unaffected both by the Finance Committee bill and by the House bill, REITs would appear to be ineligible for this deduction (as REITs generally are ineligible for the dividends-received deduction). While those dividends also would seem to continue to be qualifying income for purposes of the 95% gross income test applicable to REITs, under the proposal they also would be taken into account in calculating a REIT's taxable income and, therefore, its distribution requirement.

As a transition to territorial system which incorporates the dividends received deduction for foreign-corporate dividends described above, the Finance Committee bill, like the House bill, includes provisions treating certain accumulated earnings of certain foreign corporations as being repatriated; a portion of the amount is deductible, generally so as to result in a specific rate of tax (with a higher rate applying where the deferred earnings are attributable to cash assets). Both the Finance Committee bill and the House bill treat the accumulated deferred foreign income that would be treated as repatriated in the last tax year of such foreign corporation that begins before January 1, 2018 as Subpart F income. The mark explicitly disregards the repatriation inclusions for REIT gross income test purposes. The House bill, by contrast, does not characterize these inclusions for REIT gross income test purposes. The Finance Committee bill's clarity is helpful. Under current law, Subpart F income is not explicitly treated as qualifying income for either gross income test, though the IRS has issued a number of private letter rulings concluding, under its authority provided in section 856(c)(5)(J), that the specific Subpart F income earned by the REIT and described in the ruling would be treated as qualifying income for purposes of the 95% gross income test (though not the 75% gross income test). The approach included in the Finance Committee bill allows REITs to avoid this uncertainty.

Moreover, under the Finance Committee bill, REITs would be entitled to elect to satisfy their distribution requirement with respect to the repatriation inclusion over an eight-year period, using the same installment percentages that apply to other U.S. taxpayers. Although not explicit in the documents currently available with respect to the Finance Committee bill, presumably this would effectively take the form of the relevant installment being included in the REIT's "REIT taxable income" for the relevant year. This is important, because REITs (which are calendar year taxpayers) would otherwise have only limited time to determine, and make a distribution of, the repatriated amount; this would have put pressure on the REIT's ability to satisfy its distribution requirement for 2017, and

potentially cause it to incur excise tax and/or entity-level income tax on undistributed income. The House bill, by contrast, does not appear to permit REITs to stagger these inclusions for purposes of determining their annual distribution requirement.

Furthermore, under the Finance Committee bill, the applicable tax rate for a Subpart F inclusion generated by a repatriation inclusion is either 10% or 5% (depending on the assets in which the accumulated deferred foreign income deemed repatriated is held). This rate is achieved by providing the taxpayer which receives the corresponding Subpart F inclusion with a deduction. The documents currently available with respect to the Finance Committee bill do not specify whether a REIT would be entitled to this deduction or under which specific provisions the deduction would be provided; as mentioned above, REITs generally are not entitled to dividends-received deductions under current law. The House bill, by contrast, also provides for a deduction in an effort to tax the analogous inclusion at a specific rate, to which a REIT generally would appear to be entitled because the deduction is not housed in the dividends-received deduction sections of the Code.

Miscellaneous

Several other points are worth mentioning:

- First, REITs would in many cases (or with respect to large portions of their businesses) appear to be able to elect out of the proposed limitation on the deductibility of net business interest expense that exceeds 30% of the REIT's "adjusted taxable income." This is because many REITs (and partnerships in which they invest) are engaged in "real property trades or businesses" within the meaning of the passive-activity loss rules; those businesses are not covered by this new limitation if the taxpayer so elects. The House bill simply exempts those businesses. Mortgage REITs might be more likely to be subject to such a limitation, though the overall effect of the limitation on a mortgage REIT might not be significant given that the limitation applies to *net* business interest expense, and mortgage REITs typically expect to have substantial interest income. The breadth of the definition of a "real property trade or business" might, though, allow REITs investing in "nontraditional" REIT asset-classes to avoid this limitation. For purposes of both the Finance Committee bill and the House bill, a "real property trade or business" is defined by reference to the passive-loss rules and includes "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." While not entirely clear and presumably dependent on the specific nature of a given business, this definition might be sufficiently broad enough to cover certain businesses that have been treated for REIT purposes as involving the rental of real property, such as the operation by a REIT of data centers.

As with the House bill, under the Finance Committee bill, for those REITs (or REIT-owned partnerships) that would be subject to the limitation, this calculation generally is determined at the partnership-level rather than the partner-level, though the

partner's share of the partnership's "excess limitation" (i.e., the amount by which the partner's share of 30% of the partnership's "adjusted taxable income" exceeds the partnership's net business interest expense) can be used by the partner to absorb its directly incurred net business interest expense. Under the Finance Committee bill, disallowed interest expense could be carried to future tax years indefinitely (in contrast to five years under the House bill).

It is interesting to note that, in computing the taxpayer's "adjusted taxable income," the House bill excludes deductions for depreciation and amortization. In comparison, the Finance Committee bill's definition of "adjusted taxable income" is determined after the deduction for those amounts. Assuming that the proposal described in the Finance Committee bill is ultimately enacted, for a REIT engaged in a "real property traded or business," the amount of its cost recovery deductions (taking into account the potential benefit associated with the optional reduction in recovery periods for depreciation of real property described below) would presumably influence its decision to elect out this net interest limitation. The documents currently available with respect to the Finance Committee bill do not discuss whether the election would be made on an annual (as opposed to permanent) basis or whether it could be revoked.

This provision would apply to tax years beginning after 2017, and it would appear that this limitation on deductions for net business interest expense would replace the current earnings-stripping rules under Code section 163(j).

Both the Finance Committee bill and the House bill include other provisions intended to combat "base erosion." While both the Finance Committee bill and the House bill generally allow for the exemption of many real estate businesses from these new interest limitation rules described above, the Finance Committee bill proposes a separate limitation on deductions for net interest expense of domestic, and certain foreign, corporations that are members of "worldwide affiliated groups" ("WAGs"). For these purposes, WAGs are defined by reference to the rules for affiliated groups, except that foreign corporations are included and the relevant ownership percentage is reduced from 80% (i.e., the current ownership threshold for affiliation) to 50%. Under the rules defining which corporations are includible in an affiliated group, REITs are explicitly excluded. The Finance Committee bill does not appear to modify that exclusion. It therefore appears that a REIT would not be subject to this particular interest limitation even if it would otherwise (i.e., absent REITs not being includible members) be a member of an affiliated group.

The Finance Committee bill also proposes a tax equal to the amount by which 10% (12.5% for tax years after 2025) of the "modified taxable income" of an "applicable taxpayer" for a year exceeds its "regular tax liability" (reduced by certain credits) for the year. Modified taxable income is determined by excluding tax benefits associated with certain payments made to foreign affiliates. The Finance Committee bill would exempt certain payments to the extent that they are subject to FDAP withholding; to

the extent that FDAP withholding on the payment is less than 30%, only a proportionate portion of the payment is exempt. The clear purpose of this rule is to limit “base erosion” resulting from payments by U.S. (and certain foreign) corporations to foreign affiliates that are not subject to an appropriate level of U.S. federal income tax. Importantly, though, REITs themselves would not seem to be affected – the definition of “applicable taxpayer” does not include REITs.

The House bill also includes provisions combatting base erosion by including a somewhat similar concept, imposing a 20% excise tax applicable to certain deductible and capitalizable payments (or a portion thereof to not exempt from U.S. withholding tax) made by domestic corporations (and certain foreign corporations) that are members of “international financial reporting groups” (IFRGs) that are made to certain of their foreign affiliates. The House bill did not exempt REITs, which technically could be members of IFRGs, and also appeared to apply the tax to REIT dividends (which are generally deductible).

The interest limitation provisions under either set of proposals might have the effect of reducing the efficiency of “leveraged blocker” structures used by some foreign investors to make investments in U.S. real estate and in real-estate lending businesses, including investments through REITs. Moreover, it is possible that these provisions might affect investors in an entity and which are not members of its WAG (or, under the House bill, their IFRG), given that the proposed taxes apply at the entity level. Minority investors might, then, be advised to protect themselves against being disadvantaged by these rules as a result of other investors’ ownership.

- Second, under the Finance Committee bill, the recovery period for real property (nonresidential and residential) is reduced to 25 years. Those taxpayers electing out of the interest limitations under new section 163(j) would be required to use ADS to recover any nonresidential and residential real property and any qualified improvement property. The Finance Committee bill, however, reduces the ADS recovery period for residential real property from 40 years to 30 years. These provisions would apply property placed in service after 2017.

The Finance Committee bill also allows for immediate expensing of certain types of business assets placed in service after September 27, 2017, including property to which MACRS applies with an applicable recovery period of 20 years or less and qualified improvement property. REITs do not appear to be ineligible for these benefits. Under the House bill, by contrast, many REITs (and the partnerships in which they invest) are excluded from immediate expensing benefits by virtue of being “real property trades or businesses” (by reference to the passive-loss rules).

- Third, the Finance Committee bill, like the House bill, limits the utilization of net operating loss (NOL) carryovers. The Finance Committee bill limits the utilization of NOL carryovers to 90% for tax years beginning after 2017, and 80% for tax years

beginning after 2022. The House bill, by contrast, limits NOL carryover utilization to 90% of taxable income, and applies for tax years beginning after 2017. The House bill specifies that, for purposes of this 90% limitation, a REIT's taxable income would be the REIT's "REIT taxable income" without taking into account the dividends paid deduction (DPD). The documents currently available with respect to the Finance Committee bill do not so specify, but presumably similar clarification would be included in any forthcoming legislative language. Given that a REIT ordinarily determines its utilization of NOL carryovers after its DPD, this modification would be necessary to avoid causing a REIT to fail the minimum distribution requirement, incurring a corporate-level tax, or forgoing the NOL carryovers. Furthermore, if enacted, such a proposal (assuming that the 90% (or 80%) limitation is calculated on a pre-DPD basis) seemingly would mean that a REIT could use an NOL carryover to offset all of its REIT taxable income after paying distributions to its shareholders, provided that the REIT distributed at least 10% (or 20%) of pre-DPD REIT taxable income.

Both the Finance Committee bill and the House bill would repeal the corporate AMT for tax years beginning after 2017; current law generally treats 10% of the amount offset by the utilization of an NOL carryover as an AMT preference item.

- Fourth, as with House bill, the Finance Committee bill would appear to keep the provisions relating to foreign investment in real property largely intact, beyond reducing the corporate income tax rate applicable to foreign corporations' effectively connected income (including, generally speaking, their income subject to FIRPTA). There had been some public speculation as to whether the rules under FIRPTA might be substantially relaxed or even repealed entirely so as to incentivize foreign investment in U.S. real estate and infrastructure assets.
- Lastly, similar to the House bill, the Finance Committee bill would eliminate tax-free like-kind exchanges for all property other than real property not held primarily for sale, effective for exchanges completed after 2017. REITs often use like-kind exchanges to defer gain while disposing of their real property holdings.

RICs

KPMG observation

Provisions in the Finance Committee bill may have significant consequences for RICs, from potentially limiting RIC expenses to accelerating RIC income from investments. In addition, global asset managers of RICs may be significantly impacted by the international tax reform provisions of the proposal.

Potential limitation on RIC expense deductions

For tax years beginning in 2018, the bill would repeal all miscellaneous itemized deductions that are subject to the 2% floor. While passthrough entities are generally prohibited from indirectly deducting amounts which are not allowable as a deduction if paid or incurred directly by an individual, publicly offered RICs are permitted under current law to take miscellaneous itemized deductions at the fund level. It is unclear whether this special rule for publicly offered RICs would be affected by the proposal's general repeal of miscellaneous itemized deductions. This proposed change would expire after December 31, 2025. It is not included as part of the House bill.

Potential acceleration of RIC income and gain

The bill would revise rules associated with the recognition of income by requiring that taxpayers recognize income no later than the tax year in which such income is taken into account on an applicable financial statement. Certain fees that are treated as original issue discount on a debt instrument may be required to be included in income for financial statement purposes when received, whereas they are accrued into income over the term of the debt instrument under current law. These fees would be accelerated into income upon receipt under the proposal. While this change would have relevance to all RICs, it could have especially significant consequences to RICs that are business development companies ("BDCs") due to the substantial debt holdings of many BDCs, much of which is originated by such BDCs and involve payments of upfront fees.

This rule's impact would not be limited to debt instruments. It might also accelerate income or gain with respect to other financial instruments held by RICs.

As noted above, an exemption for RICs is provided from the bill's change to the cost basis determination rules for specified securities to prohibit the use of the specific identification method for sales of specified securities beginning in 2018. The RIC exemption would reduce the revenue estimated to be raised from the repeal of the specific identification method to approximately \$2.4 billion. This is an important issue to monitor as the tax reform process moves ahead, given that any elimination of the RIC exemption could have a profound impact on RICs and their shareholders and also could be a potential revenue raiser for other proposals.

Neither of these proposed changes is in the House bill.

Other impacts

A number of other provisions in the proposal may affect RICs:

- RICs that invest in advance refunding bonds should be aware that the bill would repeal the exclusion from gross income for interest on such bonds issued after

December 31, 2017. This proposed change is also included as part of the House bill.

For tax years beginning after December 31, 2018, the bill would reduce the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50% to preserve the current law effective tax rates on income from such dividends. Corporate shareholders in a RIC could be affected by this change as a RIC is permitted to treat its dividends as qualifying for the dividends received deduction. While this proposed change is included as part of the House bill, it would apply one year earlier (for tax years beginning after December 31, 2017).

- It is arguable that RICs should be exempt from the proposed limitation on the deductibility of net business interest expense. Net business interest expense is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income within the meaning of Code section 163(d). Code section 163(d) applies to taxpayers other than corporations. The question is whether the investment activities of RICs should be treated as giving rise to “business interest expense” which is properly allocable to a trade or business. This proposed change would apply to tax years beginning after December 31, 2017.
- The proposal’s deduction of 17.4% for certain passthrough income treated as qualified business income, effective for tax years beginning in 2018 but expiring after December 31, 2025, specifically treats dividends from a REIT (other than any portion that is a capital gain dividend) as qualified business income. However, the proposal does not extend similar treatment to ordinary dividends paid by RICs. The House bill, by contrast, proposes a maximum rate of 25% on business income earned through passthrough entities including REIT dividends, but it similarly does not provide for any reduction in the maximum tax rate for ordinary dividends paid by RICs.
- The proposal would add a new reporting requirement for corporate taxpayers. Corporate taxpayers would be required to report the total amount of dividends paid during the tax year and the first 2.5 months of the succeeding year. There are penalties up to \$250,000 with respect to any return for failure to provide such reporting by the required due date (determined with regard to any extension of time for filing.) The proposal would be effective for tax years beginning after December 31, 2018. Review of the legislative text (when available) will hopefully clarify how this requirement would affect RICs.

State and local tax implications

KPMG observation

Background

Nearly every state corporate and personal income tax conforms in some manner to the federal Code. Conformity between state and federal taxes simplifies compliance for taxpayers, and at the same time, reduces the administrative burden facing state tax authorities.

States follow two patterns in conforming to the federal income tax. Rolling or current conformity states tie the state tax to the Code for the tax year in question, meaning they adopt all changes to the Code as passed by Congress unless the state passes legislation to decouple from specific provisions. Static or fixed-date conformity states tie to the Code as of a particular date (e.g., December 31, 2016), meaning the state legislature must act to incorporate subsequent federal changes into the state tax code. States are about evenly divided between rolling and static conformity. A small number of states, notably California, adopt selected Code provisions, rather than using the blanket approach used by most states. Static and select conformity states; again, notably California; only update their conformity to the Code periodically.

Corporate overview

For corporate income taxes, states generally begin the computation of state corporate taxable income with federal taxable income and therefore allow, for state tax purposes, many federal deductions. A majority of the states start with line 28 of federal Form 1120 (taxable income before net operating losses and special deductions), and the remainder start with line 30, which includes net operating losses and special deductions. States establish their own tax rates and do not, for the most part, conform to various federal tax credits aimed at promoting various types of activities, such as credits for alternative energy sources. The research and development credit is an exception, as a number of states allow a counterpart credit based largely on the contours of the federal credit.

As noted, states do tend to pick and choose the items to which they will conform, often choosing not to conform to items that have major revenue loss consequences. For example, many states have decoupled federal bonus depreciation and the domestic production activities deduction allowed under Code section 199.

Individual overview

On the individual income tax side, most states conform to the federal definition of adjusted gross income (AGI), but seven states conform to federal taxable income (meaning they incorporate the federal standard deduction and personal exemption allowance in addition

to the AGI provisions). States that allow itemized deductions also usually conform to federal itemized deductions, with the most common model allowing all federal itemized deductions other than the deduction for state income taxes. There are 11 states that do not provide for itemized deductions.

As with the corporate tax, states establish their own tax rates and tend not to conform to a wide range of income tax credits. The earned income credit is the most common exception to this general rule. In addition, only a few states have an individual AMT.

Given these relationships between federal and state income taxes, enactment of federal tax changes that affect the computation of the tax base, by altering the income reflected or the deductions allowed would have an impact on state taxes. Changes to federal tax rates and tax credits would not, for the most part, have a direct impact on state taxes. With this as background, the state tax implications of certain of the changes proposed in the Finance Committee bill (as explained in the JCT description of the provisions) are reviewed below. Many of these provisions, particularly the individual provisions and the business tax provisions, are the same or similar to those in the House bill, which passed the House on November 16, 2017. The international provisions differ significantly from the House bill.

Individual provisions

- **Tax rates:** The Finance Committee bill retains seven individual income tax rate brackets with a maximum rate of 38.5%. These rates and all the individual income tax provisions in the bill would expire after December 31, 2025 and revert to the law as in effect before January 1, 2018. The House bill would make the rate changes and individual tax changes permanent. The revision of tax rates and brackets proposed in the bill would not directly affect state taxes as states establish their own individual tax rate structures.
- **Passthrough deduction:** Rather than reducing the tax rate applied to the income of owners and shareholders of passthrough entities as proposed in the House bill, the Senate bill would allow an individual taxpayer to deduct 17.4% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. Qualified income is defined generally to include income arising from the conduct of a trade or business, other than specified service trades or businesses (e.g. health, law, accounting, etc.). There is an exception allowing the 17.4% deduction in the case of certain taxpayers with income from a specified service business whose taxable income does not exceed \$500,000 for married individuals filing jointly or \$250,000 for other individuals. Depending on the structure of this deduction, it could potentially affect the computation of state taxable income for individuals.
- **Standard deduction, personal exemption allowance, and child credit:** The provisions in the Finance Committee bill, if enacted, would effectively double the

standard deduction for all tax filers, repeal the personal exemption allowances, and enhance the child tax credit, similar to the House bill. These changes would not automatically affect most state personal income taxes as the large majority of states with an individual income tax conform to AGI, which is computed before these factors come into play. There are, however, seven states that conform to the federal definition of taxable income for individual income tax purposes, meaning the changes in the standard deduction and repeal of personal exemptions would be incorporated into the state individual income tax.

- **Itemized deductions:** The bill proposes to repeal and revise many federal itemized deductions, including deductions for state and local income, sales, and property taxes, personal casualty losses (unless the loss occurred in a declared disaster area), and a variety of miscellaneous deductions. The bill calls for the repeal of the state and local tax deduction (income, sales and property) in its entirety for individuals, while the House bill retains a deduction for real property taxes up to \$10,000 per return. The Finance committee bill would also repeal the current limitation on itemized deductions and eliminate the current deduction allowed for certain home equity indebtedness.

As noted, the large majority of individual income tax states that allow itemized deductions conform to the federal definitions of those deductions, meaning that most of the changes would affect those states. Importantly, however, the largest component of the revenue effect of the itemized deductions appears to be from the repeal of the state and local tax income deduction, which is not allowed in the vast majority of states that allow itemized deductions.

- **Repeal of the individual mandate:** Under the Finance Committee bill, the amount of the individual shared responsibility payment enacted as part of the Affordable Care Act would be reduced to zero. There is no similar provision in the House bill. Repeal of the individual mandate would not directly affect an individual's state tax liability.

Business provisions

- **Tax rates:** The proposed corporate tax rate reduction to 20% in 2019 would not have a direct impact on state taxation as states establish their own rate structure. The reduction in federal rates may cause state corporate income taxes to be relatively more important versus the federal tax, and consequently, increase the attention paid to state tax rates if they remain unchanged. Due to the lower federal rate, the federal 80% dividends received deduction is reduced to 65% and the federal 70% dividends received deduction is reduced to 50%. These federal changes would potentially affect the state tax base in those states that conform to the federal dividends-received deduction amounts.
- **Expensing of certain assets:** The Senate bill, similar to the House bill, would increase the current 50% bonus depreciation regime to 100% expensing for qualified

assets placed in service by December 31, 2022. The proposal does not apply to certain property of regulated utilities. Unlike the House bill, the Senate bill does not extend the 100% expensing to used assets, and allows real property businesses to qualify for full expensing. This increased expensing allowance would flow through to the state tax base in rolling conformity states unless the state acts to decouple or has already decoupled from bonus depreciation. There would be no impact in static conformity states unless the state acts to adopt the change.

As noted, most states (about 30) have chosen not to conform to the existing bonus depreciation regime, largely because of the negative revenue impact. The revenue implications of the new 100% expensing provisions may be substantial both for states that conform to bonus depreciation and those that do not. The full expensing system would likely be accomplished by amendments to the current bonus depreciation law. This means that there are likely to be a minimum of compliance-related issues emanating from the change beyond those present currently in states that do not conform to bonus depreciation.

- **Interest deductibility:** The bill, if enacted, would disallow the deduction of net interest expense to the extent it exceeds 30% of a taxpayer's adjusted taxable income (ATI), with an exception for taxpayers with less than \$15 million in gross receipts (\$25 million in the House bill), certain real property businesses, farming businesses, regulated public utilities, and electric cooperatives. Unused amounts could be carried forward indefinitely. ATI is defined in the Finance Committee bill as income arising from a trade or business without regard to business interest, business interest income, the 17.4% deduction for certain passthrough entities and NOLs. This limitation would flow through to the state tax base, if a state conformed to the change.

At the federal level, the limit on interest deductibility is generally viewed as a counterpart to the 100% expensing allowed for certain assets (even though it is a permanent change and the 100% expensing expires after five years). Whether that policy carries over to states that choose not to conform to the expensing is an open question. An additional item of note is that the Finance Committee bill's definition of ATI is broader than in the House bill (where it was essentially earnings before interest, taxes, depreciation and amortization), meaning the amount of interest expense disallowed in the Senate bill is considerably greater than in the House bill. If a state chooses to conform to the interest limitation, there would be certain complexities because of the different filing methods at the state and federal level. The federal limitation would be determined at the taxpayer level, which would, in many cases, be the consolidated group level. For state purposes, a member of the federal consolidated group may be required to file a separate return or as a member of a unitary combined group. To deal with the different composition of the "taxpayer" at the state level, states often require individual consolidated group members to re-compute federal taxable income as if the member had filed separately, rather than consolidated, at the federal level. In addition, over 20 states currently have rules that disallow the deduction of

certain interest paid to related parties. Coordinating the state and federal rules in these states could also present complications.

- **Net operating loss limitations:** The bill, much like the House bill, proposes to restrict the use of net operating losses (NOLs) by taxpayers (other than property and casualty insurance companies) by eliminating the current law carryback provisions in most cases and limiting the deduction to 90% of the taxpayer's taxable income determined without regard to the deduction. For tax years beginning after December 31, 2022, the Finance Committee bill would decrease the limit to 80% of taxable income. This change would not appear to widely affect the states, as many states start their computation of state taxable income with Line 28 of the federal form 1120, which is federal taxable income before NOLs and special deductions. Other states that start the computation of taxable income with Line 30 require an addback of the federal NOL and then require computation of a state specific NOL. There are only a handful of states that adopt the federal NOL provisions. States also vary significantly in their allowance of NOL carryforwards and carrybacks. Most states do not allow a carryback and there are varying carryforward periods. In addition, several states have their own limitations (e.g., Louisiana and Pennsylvania) on the extent to which NOLs may offset taxable income. States seem likely to continue to choose their own approach to NOLs, resulting in continued complexity.
- **Repeal of other deductions and modification of certain credits:** The bill proposes to repeal or limit certain other business deductions (e.g., certain meals and entertainment expenses, transportation fringe benefits, and expenses for lobbying before local governments), albeit not quite as expansively as the House bill. To the extent a state currently conforms to a deduction, limiting or repealing the deduction would broaden the state tax base (assuming continued conformity). The most significant deduction proposed for repeal is the Code section 199 deduction to which about one-half of the states currently conform. The bill proposes to repeal certain corporation tax credits, but again the list of proposed repeals is not as extensive as in the House bill. The modification of the certain credits would not have a significant impact on state taxes.

Importantly, from a state and local government perspective, the Finance Committee bill does not propose to revise the treatment of contributions to capital by non-shareholders, a provision in the House bill that would affect certain grants by states and localities for economic development purposes. Neither does the Finance Committee bill place certain restrictions on the issuance of state and local debt to aid with economic development to the extent that the House bill does.

International provisions

As with the House bill, the Senate bill is aimed at accomplishing three objectives with respect to the treatment of foreign income and international tax reform: (a) shift the United

States from a worldwide system of taxation to a territorial system; (b) require an immediate repatriation of certain foreign entity earnings and profits that have heretofore been deferred from U.S. taxation; and (c) put in place measures to prevent the diversion of income to foreign jurisdictions once the United States moves to the territorial regime, colloquially referred to as “base erosion provisions.”

Shift to territorial system

- **Deduction for foreign-source dividends received.** The territorial system encompassed in the Finance Committee bill would allow a dividends received deduction (DRD) for 100% of the foreign-source portion of dividends received from a foreign corporation in which the U.S. recipient owns 10% or more of the voting stock. A “hybrid” dividend would not be eligible for this deduction. A hybrid dividend is a dividend paid by the foreign subsidiary for which it received a deduction or other tax benefit in a foreign country. Instead, any hybrid dividend received by a CFC from another CFC would be treated as subpart F income for the U.S. shareholders.

States often do not conform to the federal tax treatment of foreign affiliate dividends. The essential principle to which states must adhere was provided by the U.S. Supreme Court in *Kraft General Foods v. Iowa Department of Revenue*, 505 U.S. 71 (1992) where the Court held that Iowa’s conformity to federal tax law was an unconstitutional violation of the foreign commerce clause because it resulted in discriminatory treatment of dividends received from foreign affiliates as compared to domestic affiliates. As a result, many states apply their DRDs in the same manner to both foreign and domestic dividends. A number of states, but certainly not all, already allow a 100% DRD for dividends from foreign corporations. Some allow only a partial DRD, but tax an equal portion of domestic and foreign dividends. Many states also provide a reduction for subpart F income, either in the form of a specific exclusion of some or all subpart F income or a DRD that includes subpart F income. If the Finance Committee bill becomes law, taxpayers will need to evaluate how states conform to the federal DRD and the state’s treatment of subpart F income, thus determining whether the dividends qualify for deduction or exclusion under state law. Assuming the hybrid dividend is treated as subpart F income for federal income tax purposes, the hybrid dividend may also qualify for exclusion or DRD for state tax purposes.

Transition to the territorial system

- **Repatriation of deferred earnings.** To transition to the territorial system, the Finance Committee bill would require a deemed repatriation of post-1986 earnings and profits (E&P) and would subject those amounts to reduced federal tax rates depending on whether the E&P relates to cash and cash equivalents or other assets. This is accomplished by treating the post-1986 E&P as subpart F income and then allowing a partial deduction of those included amounts to arrive at the applicable preferential tax rates. The rates on repatriated earnings in the Finance Committee bill are 10% for cash and cash equivalents and 5% for other amounts, compared to rates of 14% and

7%, respectively, in the House bill. The bill would require this income inclusion in "the last tax year beginning before January 1, 2018." The Finance Committee bill would allow taxpayers the option of preserving NOLs, rather than using such NOLs to offset the deemed repatriated E&P.

Certain state issues would flow from this mandatory repatriation. As noted above, most states currently provide a reduction in state taxable income for subpart F income, but the reduction in some states is less than 100% of that income, resulting in the potential for some residual state taxable income resulting from the repatriation. The foreign commerce clause could be implicated if the undistributed earnings of domestic subsidiaries are not similarly subject to tax. In states that automatically conform to the Code, confusion could arise when computing the amount of income to be included on the state return due to the overlapping limitations provided in the Finance Committee bill and a state's DRD (or the subpart F exclusion that would otherwise apply).

Most states decouple, at least in part, from the federal NOL rules. In states that include subpart F income in the tax base, the amount of the dividend to be included will likely be based on the amount that is recognized for federal tax purposes. Therefore, if a taxpayer elects not to offset the repatriated E&P deemed dividend with NOLs, the effect of that election will likely flow through to state income. However, because bill description of the provision is not detailed, it is not certain how state NOL provisions, which frequently decouple from the federal provisions, may affect the overall state computation.

Both the Senate bill and the House bill allow the federal tax on repatriated earnings to be paid over eight years, a provision that would not likely be picked up by a state without legislative action. As a result, the full amount of any state tax attributable to the repatriation would need to be paid in a single year rather than spread over the eight-year federal installment period.

Preventing base erosion

The bill includes several sections that, if enacted, would prevent potential base erosion on both outbound and inbound transactions. While the details of the provisions differ substantially from corollary provisions in the House bill, they address similar policy goals – avoiding excessive interest and other payments to foreign affiliates. A number of state issues would flow from these new rules. Of critical importance is the foreign commerce clause prohibition of discrimination against foreign commerce, even if the differential treatment is the result of conformity to the federal income tax.

- **Rules related to passive and mobile income.** To address possible abuses related to certain types of income, the Finance Committee bill contains a provision that requires current recognition of a portion of certain income. The provision has potential consequences for state corporate income taxpayers.

Under the Finance Committee bill, a U.S. parent of a foreign subsidiary would be subject to U.S. tax on what is referred to as global intangible low-taxed income (GILTI). The calculation of this income amount is complicated and made based on certain enumerated attributes of the domestic corporation's foreign subsidiaries. This income inclusion would be required through the enactment of a new Code section. The income included under this provision would be eligible for a potential deduction equal to 50% (37.5% for years beginning after December 31, 2025) of a domestic corporation's GILTI (plus something called foreign-derived intangible income) or its taxable income.

While this provision would require GILTI to be treated as subpart F income for a number of purposes, it appears it would not be included in the definition of "subpart F income" under Code section 952. Because some states' exclusion from income (or qualification for a DRD) is specific to the definition of subpart F income provided in current Code section 952, the exclusion or DRD provisions may not encompass this new income amount. That raises the issue of a potential foreign commerce clause violation if this income earned by foreign affiliates would be taxed less favorably than similar income of domestic affiliates.

- **Limitation on interest deductions.** The Finance Committee bill would limit interest that may be deducted by U.S. members of a multinational group. The stated purpose of this provision is to curtail disproportionate borrowing, and related interest expense deductions. To this end, the Finance Committee bill includes a formula for determining the amount of interest expense that would be considered proportionate for the U.S. members, based on the overall debt-to-equity ratio of the entire multinational group. Any excess interest would be disallowed, but could be carried over indefinitely. The provision would work in conjunction with the more generally applicable interest limitation discussed above, with the amount of interest disallowed being the greater of the two. In addition, the Finance Committee bill would disallow deduction for certain interest and royalty payments made to members of some multinational groups.

Many states currently disallow certain interest and/or royalty payments made to related parties. However, if the federal law results in disallowance of amounts that are not otherwise disallowed by the state expense disallowance provisions for payments to U.S. affiliates, conformity to the federal law could run afoul of the foreign commerce clause. Further, some states have an exception to their addback provisions that applies to amounts paid to a related party in a jurisdiction that has a tax treaty with the United States or amounts that are subject to tax in a foreign jurisdiction. In those states, certain interest deductions may be limited under the federal proposal, even though the payment otherwise qualifies for an exception to the state addback statute. Also, because the state filing group may differ from the federal consolidated group, the computation of the interest limitation may be challenging and could further foreign commerce clause issues.

- **Base erosion minimum tax.** The proposed base erosion provisions also include a “base erosion minimum tax” for certain inbound transactions. The tax would be applicable to certain enterprises with greater than \$500 million in annual gross receipts in the preceding three years. The tax would be based on the excess income that would have been reported by the U.S. corporation without taking into account certain amounts paid to foreign affiliates. Given that this is a new, separate tax calculation, it is possible there would be no state tax effect because the tax would not cause a change to the taxable income of the corporation.

The above discussion has focused on whether certain foreign-source income would be included in the state income tax base and made note of the U.S. constitutional requirement for its treatment. Beyond this, there would be a host of additional considerations that need to be taken into account in cases where the federal change would flow through to the state base. For the most part, these considerations are not new. They include considerations of whether the income is unitary and subject to apportionment or non-unitary and subject to allocation. If subject to apportionment, taxpayers would need to consider the method used by individual states to source that type of income for apportionment factor purposes, which can differ depending on whether the income is from dividends, interest, capital gains, inventory sales, and the like. While not new, they will require careful analysis.

Closing thoughts

For the last 12 months, there has been much speculation in the state tax community as to the effect federal tax reform, if enacted, would have on the states and how states would react. Until now, the speculation has been based on vague plans and general concepts. The availability of the House bill and the Senate bill, even with some key differences between them, make it possible for states and taxpayers to further delve into the state implications of these far-reaching potential changes. The interrelationships between state and federal income taxes are such that any federal changes will necessarily have implications for state taxes.

In evaluating the implications, taxpayers will need to keep a few fundamentals in mind. First, the reaction to federal tax reform by individual states would, to a considerable extent, be driven by the fiscal impact of conformity to the revised federal code. State balanced budget requirements will have an out-sized influence on whether and to what extent states conform to the federal changes. Simply put, states do not have the ability to run a deficit under their typical one- or two-year state budget cycles.

Second, there would likely be indirect effects as a result federal tax reform that states would consider. Certain of the proposed changes, such as the repeal of the state and local tax deduction for individuals, would increase the after-tax costs of state and local

government at a time when federal resources are likely to be constrained and reduced federal assistance may be available.

Third, timing is everything. If federal tax reform is passed in late 2017 effective for the 2018 tax year, states will have an extremely limited time to assess the fiscal and tax effect of the federal changes by the time state legislatures convene in early 2018. Some states may— out of necessity— simply delay addressing the changes until the impacts can be analyzed fully. This could be accomplished by freezing conformity to a pre-tax reform year, a step that would likely lead to a significant disconnect between federal and state tax laws—at least in the short-term.

Finally, there is no “one size fits all” state or state taxpayer response to federal tax reform. The proposed federal changes would affect each state differently and would need to be carefully analyzed by state tax administrators and state legislators so that the state can formulate a response. The effect on individual taxpayers would also vary widely and would depend on the taxpayer’s particular situation, current state filing position, and industry.

Impact of tax reform on accounting for income taxes

Remeasurement of current and deferred taxes

Accounting Standards Codification (ASC) Topic 740 requires the determination of income tax expense (benefit), income taxes receivable (payable) and deferred tax assets (liabilities) to be based upon currently enacted tax laws and rates. The effects of changes in tax laws or rates are generally reflected for financial reporting under U.S. generally accepted accounting principles in the interim period that includes the date of enactment; in other words, for U.S. federal income tax purposes, the period the President signs legislation into law.

The tax effect of a change in tax laws or rates on income taxes receivable (payable) for the current year is recorded after the effective dates prescribed in the statutes and reflected in the computation of the estimated annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. In some instances, a change in tax laws or rates may have retroactive effect. In those instances, the effect of the change on income taxes receivable (payable) for a prior year is recognized as of the date of enactment.

Deferred tax assets (liabilities) are remeasured to reflect the effects of enacted changes in tax rates and other changes in tax law when the law is enacted, even though the changes may not be effective until future periods. Companies will need to consider the timing of reversal of temporary differences that exist as of the enactment date. If the enactment date is different from an entity’s normal closing cycle, a company should make reasonable efforts to estimate the temporary differences at the date of enactment.

In addition, although the bill calls for a one year deferral (phase in) of the corporate tax rate reduction, changes in the tax law may also phase out over a period of time, or the change in tax laws or rates may sunset and revert to existing tax laws or rates. Accordingly, companies may need to perform some level of scheduling of temporary differences to determine the appropriate tax laws and rates to measure deferred tax assets and liabilities. The existing tax laws and rates should continue to be used to measure deferred tax assets and liabilities for those temporary differences scheduled to reverse prior to the effective date, while the new tax laws and rates should be applied to temporary differences that are scheduled to reverse after the effective date. If new tax laws or rates included in the final enacted legislation sunset, then reversion to the existing tax laws and rates would be applied to those temporary differences scheduled to reverse after the sunset date. Therefore, companies may need the systems and processes to understand what years the tax basis of its existing assets and liabilities will reverse and what years the related financial reporting carrying amounts are expected to reverse.

Potential changes in significant judgments

Although remeasurement of deferred tax assets and liabilities may be prevalent, there are additional financial reporting impacts to consider with respect to changes in tax laws and rates. For instance, lower tax rates in the U.S. can reduce a company's tax liability before tax credits and impact the company's ability to utilize certain tax attributes such as foreign tax credit carryforwards and general business credit carryforwards. A company may need to reassess whether there will be sufficient taxable income of the appropriate character in a given period to realize the deferred tax assets associated with operating loss and tax credit carryforwards. To the extent that deferred tax assets are not more likely than not to be realized, the deferred tax assets should be reduced by a valuation allowance to the amount that is more likely than not of being realized. To the extent additional limitations are introduced as part of the change in tax law, those limitations may result in a change to an entity's valuation allowance judgment. For instance, if an interest expense limitation is included in the final enacted legislation, entities may see a significant increase in taxable income that may result in the release of an existing valuation allowance on U.S. federal deferred tax assets. The reassessment of an entity's valuation allowance judgment should be performed as of the date of enactment in conjunction with the remeasurement of deferred tax assets and liabilities.

A participation exemption and the potential mandatory taxation of foreign earnings may result in a change of an entity's intentions and its ability to meet the indefinite reversal criteria for its investment in foreign subsidiaries. Deferred tax assets and liabilities, or income taxes receivable or payable, may need to be recorded in the period that includes enactment. If an entity has historically asserted that its investments are indefinitely reinvested, certain information required to measure deferred tax assets and liabilities or income taxes receivable or payable, including the balance of earnings and profits and tax pools, may not be readily available. Entities may also need to consider the

remeasurement of existing deferred tax assets and liabilities on investments in subsidiaries based upon the provisions of the enacted tax law. As part of this assessment, entities should continue to apply the guidance that prohibits the recognition of a deferred tax asset unless it becomes apparent the temporary difference will reverse within the foreseeable future.

There may be elements of the new legislation where it is not entirely clear how a court would interpret the law. Accordingly, companies should also assess what impact the new law will have on the accounting for uncertainty in income taxes. If there are tax positions expected to be reported on a tax return that are not more likely than not or are not highly certain to be sustained upon examination based on the technical merits, a company should determine the appropriate amount of unrecognized tax benefits to record in the financial statements.

Intraperiod tax allocation

The entire impact of changes in tax laws and rates is recorded as a component of income tax expense or benefit related to continuing operations in the interim period that includes enactment. If material, the effect of the changes in tax law or rates should be disclosed in the notes to the financial statements.

If enactment occurs subsequent to a period end, but prior to the issuance of the financial statements, and the impact is anticipated to be material, disclosure may be necessary if non-disclosure would be misleading to a reader of the financial statements, while the effects are not recorded until the interim period in which the enactment occurs.

Summary

This discussion highlights some anticipated common areas of accounting for income taxes resulting from a change in tax law or rates, but it is not all inclusive. An entity's specific facts and circumstances should be assessed in determining the accounting for income taxes impact as additional insight into final legislation is obtained.

KPMG contacts

For more information on any of the provisions discussed in this booklet, please contact a professional in KPMG's Washington National Tax office.

Tax technical area	Name	Email	Phone
Passthroughs	Deborah Fields	dafiels@kpmg.com	+1 (202) 533-4580
Global mobility services	Martha Klasing	mklasing@kpmg.com	+1 (202) 533-4206
	Joan Smyth	jsmyth@kpmg.com	+1 (202) 533-4404
Corporate	Mark Hoffenberg	mhoffenberg@kpmg.com	+1 (202) 533-4058
	Rob Liquerman	rliquerman@kpmg.com	+1 (202) 533-3054
Compensation and benefits	Karen Field	kfield@kpmg.com	+1 (202) 533-4234
	Terri Stecher	tstecher@kpmg.com	+1 (202) 533-4830
Estates, gifts, and trusts	Tracy Stone	ttstone@kpmg.com	+1 (202) 533-4186
Insurance	Frederick Campbell-Mohn	fcampbellmohn@kpmg.com	+1 (212) 954-8316
	Sheryl Flum	sflum@kpmg.com	+1 (202) 533-3394
Regulated investment companies	Deanna Flores	djflores@kpmg.com	+1 (858) 342-7661
Banking	Elizabeth L'Hommedieu	elhommedieu@kpmg.com	+1 (614) 249-1849
	Matthew Mosby	mmosby@kpmg.com	+1 (704) 371-5265
Other financial products & debt	Kevin Keyes	kkeyes@kpmg.com	+1 (202) 533-3577

	Jon Zelnik	jzelnik@kpmg.com	+1 (202) 533-4193
Exempt organizations	Greg Goller	greggoller@kpmg.com	+1 (703) 286-8391
	Alexandra Mitchell	aomitchell@kpmg.com	+1 (202) 533-6078
International	Manal Corwin	mcorwin@kpmg.com	+1 (202) 533-3127
	Seth Green	sethgreen@kpmg.com	+1 (202) 533-3022
	Danielle Rolfes	drolfes@kpmg.com	+1 (202) 533-3378
Mergers & acquisitions	Thomas Wessel	twessel@kpmg.com	+1 (202) 533-5700
International M&A	Devon Bodoh	dbodoh@kpmg.com	+1 (202) 533-5681
Income tax accounting	Eric Lucas	ejlucas@kpmg.com	+1 (202) 533-3023
Economic & valuation services	Stephen Blough	sblough@kpmg.com	+1 (202) 533-3108
Energy	Rich Blumenreich	rblumenreich@kpmg.com	+1 (202) 533-3032
	Robert Swiech	rswiech@kpmg.com	+1 (713) 319-3257
Financial institutions and products	Mark Price	mhprice@kpmg.com	+1 (202) 533-4364
Accounting for income taxes	Ashby Corum	acorum@kpmg.com	+1 (313) 230-3361
	Jenna Summer	jsummer@kpmg.com	+1 (202) 533-3614
State and local tax	Harley Duncan	hduncan@kpmg.com	+1 (202) 533-3254
	Ann Holley	aholley@kpmg.com	+1 (202) 533-3248
Excise and credits	Deborah Gordon	dkgordon@kpmg.com	+1 (202) 533-5965
	Taylor Cortright	tcortright@kpmg.com	+1 (202) 533-6188

REITs	David Lee	dwlee@kpmg.com	+1 (202) 533-4071
	Stephen Giordano	stephengiordano@kpmg.com	+1 (202) 533-3535

Contact us

For questions on legislative matters, contact a professional in the Federal Legislative and Regulatory Services group of the Washington National Tax office:

John Gimigliano

T +1 (202) 533-4022
E jgimigliano@kpmg.com

Carol Kulish

T +1 (202) 533-5829
E ckulish@kpmg.com

Tom Stout

T +1 (202) 533-4148
E tstoutjr@kpmg.com

Jennifer Bonar Gray

T +1 (202) 533-3489
E jennifergray@kpmg.com

kpmg.com/socialmedia



The information contained herein is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 145,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International. NDPPS 669194